S. HRG. 107–412

THE 7(a) LOAN GUARANTY PROGRAM: A LOOK AT SBA'S FLAGSHIP PROGRAM'S FEES AND SUBSIDY RATE

ROUNDTABLE

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

SEPTEMBER 5, 2001

Printed for the Committee on Small Business and Entrepreneurship

Available via the World Wide Web: http://www.access.gpo.gov/congress/senate

U.S. GOVERNMENT PRINTING OFFICE

78–869 PDF WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
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THE 7(a) LOAN GUARANTY PROGRAM: A LOOK AT SBA'S FLAGSHIP PROGRAM'S FEES AND SUBSIDY RATE

WEDNESDAY, SEPTEMBER 5, 2001

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP,
Washington, D.C.

The Committee met, pursuant to notice, at 9:45 a.m., in room SR–428A, Russell Senate Office Building, the Honorable John Kerry (Chairman of the Committee) presiding.

Present: Senators Kerry, Wellstone, Bond, and Bennett.

Chairman KERRY. Good morning, everybody. Thank you very, very much for being here and joining us today. Good morning and welcome back to my colleague.

Senator BOND. Welcome back to you, Mr. Chairman.

Chairman KERRY. I think these roundtables have proven to be a really helpful way for us to do some business. I am not sure, but I think you began them, didn't you, Senator Bond?

Senator BOND. With your active concurrence and support.

Chairman KERRY. With my very positive input. It is a really productive way to have more of a dialog and to be able to exchange thoughts and get a roundtable going rather than just the formality and strict confines of the normal hearing process. So we are particularly appreciative for all of you participating today. A number of you have been very much part of 7(a) lending for some period of time.

We are glad to welcome John Whitmore here, who survived the task of running the agency for awhile, and takes over as the principal assistant to the Administrator now. We are glad for that experience also. GAO, thank you for being here with us with your team of experts, both at the table and in the audience. I know you have spent several months in trying to analyze this issue and, hopefully, we can really make some progress here today.

Obviously, the crux of what we want to get at today is this estimated default rate issue since 1992, and why it has differed so drastically from the actual performance and, needless to say, what the impact of that is on the clients, on the participants in the process. Let me just lay out very quickly the parameters of that problem, as I see them.

Since 1992, SBA and OMB have overestimated the original cost of the 7(a) program by more than $1 billion. From 1992 to 1998 alone, the 7(a) program, with interest included, returned about $1.3 billion to the Treasury. Congress, on the other hand, appropriated about $1.4 billion to run the program in those years. So GAO's study, as we will hear a little later on, attributes most of that overestimate to overly pessimistic estimates of the default rates that were plugged into the subsidy rate formula. I think, specifically, SBA originally overestimated defaults from 1992 to 2000 by about 87 percent, when compared to the actual loan performance.

If the subsidy rate reflected the actual performance of the 7(a) program, and current fees continue to be charged to borrowers and lenders, then the program would run at a negative subsidy rate, in effect, making money for the Federal Government. That means that Congress has needlessly appropriated too much to fund its share of the program, small business owners have paid too much in fees to access the loans and lenders have paid too much in fees to make the loans. So we need to examine this question and really look at the bottom-line issue, which is that even though the 7(a) program effectively has been running at a profit to the Federal Government, it has been doing so at the expense of small business borrowers and lenders, and the Administration's 2002 budget proposal, which eliminated funding for 7(a) loans and increased fees to cover the cost, represents something of a contradiction, if not a question mark, under those circumstances.

So, today we want to dig into this and get a sense of how we might, together with experts, practitioners and others, be able to rectify this situation. What is the appropriate response to it? There's a question as to what the Government is "subsidizing," when the program itself has returned more than $1 billion to the Treasury since 1992? Senator Bond and I, as you know, put an amendment in the final budget resolution that restored funding for the program and opposed the fee increases, based on our sense of how this balance ought to exist. I would like to see today if we can come to an agreement and an assessment of how we ought to approach this. Senator Bond, do you want to add anything to that?

Senator BOND. Certainly. First, sincere thanks to you, Mr. Chairman, for convening this roundtable. As we explained to Dr. Blanchard when we welcomed him, this is a way to give the maximum participation for the leaders in this field. It is a little different format, but I very much appreciate your having this one, because I think it is important that we get right through to the heart of this matter. I know this is a busy time. I appreciate you scheduling it. I apologize, but I am on the Defense Appropriations Subcommittee and Secretary Rumsfeld is going to be there at 10 a.m., and I think there is a little controversy swirling around that we are going to have to be involved in there. So I am going to have to leave. My staff is going to be here.

I want to join with you in commending John Whitmore. I tell you what, John did a fabulous job and we appreciate your stepping in and helping. It has been great to work with you. You may have heard—some of you have been here at earlier hearings when I have been extremely critical of the Administration's fiscal year 2002 budget request for the SBA, and I said some very strong comments about OMB. I wanted the record to note that Dr. Blanchard was not there. He comes in without having responsibility for some of the things that I think resulted from this significant misunderstanding, and I hope that, working together, we can get back on the same page. I think this will give him an opportunity to interact, perhaps, even ask some questions of people here, so we can all be working together.

If the legislative branch and the executive branch and the private sector work together, there is no telling what we could do, and frankly, when it comes to small business, that is the only way we get things done. There are lots of big, big issues that are floating around that command the headline coverage, the top of the nightly news. Small business is vitally important, but it usually does not make it as a high-profile issue, so if we get everybody working together, and this Committee has worked on a bipartisan basis as well or better than any committee I know, and when we speak, we speak as Republicans and Democrats. That is the way we get things done.

The Chairman has already talked about the problem. According to the GAO, defaults were overestimated by nearly $2 billion and that means that under the credit subsidy scoring, the Federal Government collected significantly more than it needed to fund its loan loss reserves. I think they said, specifically, the Federal Government collected over $950 million in excess fees paid by borrowers and lenders. My shade tree analysis leads me to believe that small business borrowers, banks and taxpayers have been and continue to be overcharged for the 7(a) program. It is clear they are paying too much each year, because the SBA and OMB overestimate the default rate.

Second, if a more accurate default rate were adopted, the credit subsidy could be reduced. Third, a lower credit subsidy rate would mean lower fees paid by small business borrowers. Fourth, the 7(a) loan program could expand to meet the demands of small business without requiring the larger appropriations. I do not need to tell anybody in this room that this is the time in our economy and in our history when we need small business to be in a position to expand. Brother, do we need it now. All those $300 and $600 rebate checks got to go somewhere, and we might as well expand small business to take advantage of them.

There are a number of other questions that we have. I will have a fuller statement for the record, but I appreciate very much, Mr. Chairman, your holding this hearing, and I apologize to you and to the participants, but I am going to have to go find out what is going on in the defense budget.

Chairman KERRY. Senator, I thank you very much. I understand that completely. I just came from a joint leadership meeting, which we had actually both this morning, and we sort of acknowledged that we have about 12 legislative days this month, given both the Jewish holidays falling for the first time in a long time within the week. So that, plus the demonstration that is planned in Washington around the IMF, probably making work hard in the city and so forth, really reduces the time we have available. Like you, I am going to have to dart in and out. I will be here for part of this discussion, but we have not gotten any conference report yet passed on any appropriations bill. We almost certainly are looking at a short-term CR, but there is a lot of work to be done so we are going to be pressing it as hard as we can.

What I would like to do is invite, in our absence, our able staff. Patty Forbes and Paul Cooksey will conduct the meeting. Then I will return. I have to go over to a couple of other committees. We have five presentations. I would like to ask each of them to be kept to the 2-minute range, if possible. That will be as an opener to the discussion, at which point each participant would seek recognition from Patty simply by either raising your hand or just holding your nameplate up, and she will duly record it and put you in line to speak. I do not want anybody to feel constrained. If there is an immediate rejoinder to something, let's have a good discussion and get at it that way.

If I could invite the economist from NFIB, Bruce Phillips, why don't you lead off and then we will just go down the line. Tony Wilkinson, Linda Calbom, Lloyd Blanchard, and John Whitmore; and then we can engage in the discussion from there.

Thank you, Bruce.

STATEMENT OF BRUCE PHILLIPS, SENIOR FELLOW IN REGULATORY STUDIES, NATIONAL FEDERATION OF INDEPENDENT BUSINESS EDUCATION FOUNDATION

Mr. PHILLIPS. Thank you. Good morning, Senator Kerry and members of the roundtable. I appreciate being asked to say a few words about the importance of small firms, having worked in this area for almost 30 years, as well as the availability of debt capital for new and growing small businesses. These remarks are mine only and do not represent either NFIB, with whom I am now affiliated, or the SBA, with whom I spent over 20 years.

Why are small firms important? Market flexibility and opportunity for about 16 percent of all small firms are new each year and about 14 percent leave the market, approximately at a 30 percent turnover rate, generally for voluntary reasons. That is an average 2 percent growth rate annually in the number of new-employer firms. The high business startup in business formation rates of the small business sector are among the highest in the world and are envied by just about every developed Nation in the world. They help keep our unemployment rate lower than it otherwise would be, and this is as true today as it ever was and is a major strength of our economy.

Many small firms, about 40 percent according to some of the latest NFIB figures, are adding jobs today while large companies are eliminating them. New business formation requires capital, especially debt capital during the early startup phases. After credit card loans of around $50,000 to $75,000, where do new firms go? To family, friends, and the SBA. Why the SBA? Because unlike most banks, the SBA does startup loans more and more—about a quarter of the 60,000 7(a) loans made annually go into startups. Many more than that go into the mini- or the micro-loan programs. Both have excellent repayment records. SBA has the only program with a 7–9-year repayment period and is a major source of funds for lending to minorities and women, especially in inner-cities and rural areas.

What have the bank lending markets been like? SBA advocacy research has shown that large, local consolidations make the national effective mergers difficult to judge, but we do know consolidations have significantly reduced the number of banks, especially in rural areas. Some local areas may be negatively impacted, but offer difficult measurement problems, despite the excellent research of the Federal Reserve. Credit scorings probably helped some borrowers with good credit, but hurt others that need credit the most and have more marginal personal credit records. SBA bank lending studies show large increases in micro-loans under \$100,000, about 20 percent in the last available year, but not a large increase in dollars, less than 7 percent—I think it was from 1999 to 2000.

By contrast, there have been double-digit percentage increases in loans over \$1 million, which generally go to larger firms. It is still very difficult for new small firms to borrow large amounts of money. To make large loans, many banks require a new firm to bring equity to the table. Quite frankly, they do not have it. Our banks want rapid repayment, within 1 to 2 years. New firms often cannot make these kinds of repayment schedules either. A critical issue, especially during these uncertain times, is the importance of a mechanism which allows very small employers and self-employed individuals to grow and hire their first employee. Often this has been difficult for very small minority firms, the vast majority of which represent self-employed individuals.

It is not quite as well known, but only about 15 percent of minority firms have employees. The rest represent self-employed people. The SBA has been and should continue to be a major player in making early debt capital available to all firms that need it at an affordable price. The loan prices will allow very young and startup small firms to continue to grow and create jobs and pay taxes, and hopefully, qualify for larger firms in the future in the private market.

I would be happy to answer any questions later that the roundtable might have.

Chairman KERRY. Thank you very much.

Tony.

STATEMENT OF TONY WILKINSON, PRESIDENT, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS, INC., STILLWATER, OK

Mr. WILKINSON. Mr. Chairman, first of all, I want to thank you and Senator Bond and your staff for holding today's roundtable hearing. This is a day we have been looking forward to for quite some time. Again, a big thanks, because there is a lot of work that goes on behind the scenes before we ever get to this point. Thank you very much for having today's hearing.

Chairman KERRY. Well, you have been here a lot and have been part of this for a long time, so, thank you for your help.

Mr. WILKINSON. I had the opportunity to attend a conference a few weeks ago, the American Society of Association Executives, and Bernard Shaw was a keynote speaker. He thanked the associations for being the early warning system for our elected officials in Washington. That is part of the message I wanted to deliver today—our warning sirens are going on. At a time when loan volumes should be going up, it is going down. At a time when we need lender participation to increase, lenders are getting out of the program. It is something that needs to be addressed.

The main problem, as we see it, has been an inaccurate subsidy rate calculation. We have been before this Committee and the House Small Business Committee for years testifying that the default rate in the model is simply unreasonable, way too high, and now we see in the downward reestimates in the budget that that is the case, that we are sending many of our dollars straight to the Treasury. Mr. Chairman, you alluded to the fact that we sent $1.3 billion to the Treasury while $1.4 billion has been appropriated. If we just stop today and quit, there is going to be more money that flows to Treasury. By the time we get through, there is going to be more money going to Treasury than was originally appropriated. From our perspective, that is a tax on small business. I do not know where authorization came to tax small businesses that use this program and we hope that that gets addressed and discussed today.

Next, I want to thank Dr. Blanchard for engaging in our issue. I know he is new to this, and I had a chance to briefly visit with him beforehand. I do appreciate all his efforts and the efforts of his staff to get involved. At the same time, I want him to understand why we are frustrated and concerned about what has happened in the past. Again, since 1995, we have repeatedly pointed out that the SBA's model is inaccurate.

Second, we have been supported in that argument by both the Senate and House Small Business Committees. Last year, in one of the hearings, the Administrator of the SBA testified that the program was being run at a profit to the government.

Third, according to GAO, SBA has repeatedly suggested methodology to correct the inaccurate calculation of the subsidy rate, yet OMB has rejected every one of those even knowing that the program was running at a profit.

Fourth, we met with OMB last year and we were told that they would take a look at the problem, but only when language appears in the House Treasury-Postal Appropriations bill does action begin to be taken.

Fifth, OMB has never supported SBA's request for $4 million to develop an econometric model. Now it does?

Sixth, Mr. Whitmore has done a great job and I appreciate his efforts, but I do not think John is an expert on econometrics or the subsidy rate calculation—and I wonder why the SBA left all their CFO representatives at home today. Nobody is here from their shop to discuss the issue.

Seventh, SBA has repeatedly told its lending partners that it is not ready to develop an econometric model, and out of discussions last week, we understand that may be the option for fiscal year 2003. We wonder how, out of the blue, all of a sudden we can have a new econometric model. We are obviously concerned that we have now cracked the old black box, are we simply going to get into a new black box?

We are not going to get hung up at NAGGL on what methodology we use—3-year look back, 5-year look back, post-1991 guaranties. That to us is not the answer, although it is a healthy discussion, and I think these folks, even before the meeting started, they were engaging in that. What we hope comes about is a fair, accurate calculation, that when we come to the end of the day or over a period of time, that the reestimates approximate zero. The Credit Reform Act says that SBA and OMB should give Congress the cost of the program, not give Congress the cost of the program plus a huge, great, big cushion to fall back on. Over time, we should get to a subsidy reestimate that approximates zero. Some years were too high, some years were too low, but off we go.

Last, we think there needs to be some measure of accountability for the decisions that SBA and OMB make. Where are they held accountable when they err? Thus far, it is the language in the Treasury-Postal Appropriations bill, and rest assured, we are going to continue to push that angle. But, hopefully, today we can have some good discussions and come to some conclusions.

Thank you.

[The prepared statement of Mr. Wilkinson follows:]

The Answers You Trust
The Training You Expect
The Voice You Need

Statement of

The National Association of
Government Guaranteed Lenders, Inc.

By

Anthony R. Wilkinson,
President and Chief Executive Officer

For the

Senate Committee on Small Business and Entrepreneurship

September 5, 2001

The National Association of Government Guaranteed Lenders, Inc. ("NAGGL") is a trade association for lenders and other participants which make approximately 80% of the Small Business Administration ("SBA") section 7(a) guaranteed loans. The SBA's 7(a) guaranteed loan program has proven to be a very valuable public/private partnership. Since the program's inception, the SBA has made or guaranteed more than 600,000 loans totaling approximately $80 billion. We thank the Committee for the opportunity to comment on the SBA 7(a) program.

We believe the SBA 7(a) program is at a critical crossroads. Lender participation is declining. Earlier this year, the highest volume 7(a) lender in the country exited the program because it "could not meet its rate of return goals." Loan volume for this fiscal year is down from last year. Volume is down even though legislation passed last December that made improvements to the program. For instance, the maximum SBA 7(a) guarantee was increased to $1 million. Some SBA officials estimated that that change alone could increase loan volume by $1 billion. But instead, loan volume and lender participation are down.

Federal Support for 7(a) Loans

We believe two important issues must be dealt with as soon as possible. First, the Small Business Committees need to determine the level of Federal support which should be provided for credit subsidies. Since the beginning of "Credit Reform" in 1992, the SBA 7(a) subsidy rate has fallen from a high of 5.21% to the projected current services level for FY 2002 of 1.07%. This represents an 80% reduction in the estimated cost of the program to the government. This reduction in subsidy costs has been achieved by improved underwriting guidelines, establishment of lender review procedures, and fee increases on both borrowers and lenders. Yet at the same time, appropriations have declined from a high of $334 million down to the current year level of $115 million. The program improvement dollars have not been used to provide subsidies for small business loans. Rather the dollars have been used elsewhere.

The Administration's FY 2002 budget request proposes to continue this trend by totally eliminating all appropriations for the SBA 7(a) program. Fortunately, both the Small Business Committees and the Appropriations Committees have disagreed with the budget request, and it appears some level of subsidies will be provided in FY 2002. We hope that subsidies will continue to be provided in future years.

Accurate Subsidy Rate Calculations

The second issue that must be dealt with is for OMB to come up with a subsidy calculation that is reflective of the current SBA 7(a) program. For several years, NAGGL has been testifying before this Committee, the House Small Business Committee, and the respective Appropriations Committees that the subsidy estimate for the SBA 7(a) program has been far in excess of the program's actual cost. The main problem in the subsidy calculation has been the use, by OMB, of excessive default, or repurchase estimates. In written testimony dated May 1, 1997, NAGGL testified before this Committee on this very issue. In that testimony we stated:

> "The FY 1996 performance of 7(a) loans resulted in a $100 million profit to the Treasury. This means the cost of the program, or the subsidy rate, has been estimated too high. The FY 1998 budget request continues this procedure by using overly-conservative default estimates. The defaults on SBA 7(a) loans made since the Credit Reform Act has passed has been statistically estimated at just over 10%. Yet in the FY 1998 budget request, OMB estimates 16.25% in defaults. Just like this year, OMB has used a default estimate much higher than necessary....In short, the members of this Committee and of the Appropriations Committee have, in NAGGL's view, been boxed in by an unreasonable

> implementation of the Credit Reform Act. NAGGL has no problem with today's borrowers and lenders paying their fair share of the cost of the program. But the government's cost of loans made today must be evaluated on today's loan program, not the loan program of the early 1980's and any reviews must be based on a statistically valid evaluation of the program."

Every year since that testimony, OMB has continued to use default estimates far in excess of actual performance, and every year NAGGL has testified that program participants are being overcharged. And every year since, OMB reports sizeable downward re-estimates for the 7(a) program. The re-estimates, or excess program fees, now total $1.258 billion. That number is expected to continue to grow.

In a FY 2000 budget submission document from the Office of the Chief Financial Officer, the SBA commented on the sizeable re-estimates. **"A re-estimate results when our original assumptions were incorrect. However, had we known the direction and magnitude of our inaccuracies, we would most certainly have corrected for them."**

Yet, in testimony before the House Small Business Committee just last year, an SBA official testified that the estimated default rate for the SBA 7(a) loan program was "in the 8%-10% range." At the same House Small Business Committee hearing last year, the then-SBA Administrator testified "the program is already being run at a profit to the government." Yet OMB requires the use of an approximate 14% default rate in the subsidy rate calculation. **The SBA acknowledged that the default estimates used in the 7(a) model were substantially inaccurate, yet no corrections have been made.**

Each 1% reduction in the default estimate would reduce the subsidy rate by approximately 34 basis points, or .34. If the highest SBA default estimate of 10% (per the House testimony last year) were used, the current subsidy rate of 1.17% would be reduced by over 120 basis points. This would mean that the subsidy rate today is already below zero. This fact was recently confirmed in a review by GAO. According to GAO, the average default rate on post-1991 loans is only 8.81%. According to GAO, the current year subsidy rate would be –0.54 using the post-1991 loan guarantee data.

Since the default rate on post-1991 loans is estimated by GAO at 8.81%, sizeable downward re-estimates will continue. Already, $1.258 has been returned to the US Treasury. More is yet to come. In fact, every single dollar appropriated since 1992 for credit subsidies, plus dollars from borrowers and lenders, will end up at Treasury. This gives the appearance, in our opinion, that OMB is ignoring the will of Congress to provide credit subsidies for the SBA 7(a) program.

NAGGL Encourages Continued Congressional Support

There are many positive attributes of the SBA 7(a) loan program, including:

- SBA loan programs provide as much as 40% of all long-term loans (loans with maturities of three years or longer) to small businesses.
- SBA 7(a) loans have significantly longer maturities than conventional loans to small businesses. The average original maturity of SBA 7(a) loans, according to the Office of Management and Budget ("OMB"), is 14 years. By comparison, only 16% of conventional small business loans have maturities in excess of one year, and of those loans, the average maturity is less than four years.

- Longer maturities mean substantially lower monthly payments for borrowers. For example, the difference in monthly payments from a 10 year SBA 7(a) loan to a five year conventional loan (which would be above the average maturity for conventional loans), would be 35-40%. This is a significant increase for the average SBA borrower who tends to be a new business startup or an early stage company.

- Small businesses do not have the same access to capital as do large businesses. The SBA programs bridge that capital gap. Banks cannot be expected to make long-term loans, the kind most needed by small business, when banks are funded by a short-term deposit base.

- The SBA 7(a) appropriations are leveraged almost 99 to 1 by the private sector, making this one of the governments' best economic development instruments. With a more accurate subsidy rate estimate (as discussed below), the leverage ratio would be even higher.

- The SBA 7(a) loan program is just that – a loan program – which helps qualified small businesses obtain the long-term capital they need for growth and expansion. This means jobs, and a "net return on investment" for our local communities and the US Treasury.

NAGGL requests your support for continued appropriations for the SBA 7(a) program. We urge you to make sure there remains a viable, usable SBA 7(a) loan program by passing our proposed fee decreases and providing sufficient appropriations to support an $11 billion SBA 7(a) loan program for FY 2002. Additionally, NAGGL requests that Congress takes whatever steps are necessary to assure that the subsidy calculation for the SBA 7(a) program is fair and reasonable. NAGGL believes that the intent of the Credit Reform Act is for cumulative re-estimates to approximate zero.

A copy of the NAGGL proposed legislative changes is attached to this statement. The legislation would decrease lender fees in hopes of maintaining/increasing lender participation. It also would increase the size limit of "small loans", which automatically reduces the borrower fees on these loans. The revenue loss of these changes should be minor and should be easily accommodated by adoption of realistic, accurate default estimates. If OMB/SBA agree to use only post-1991 loan guarantee data, even more dollars should be available to reduce program fees further. NAGGL would then encourage additional reductions in guarantee fees paid up-front by the borrower.

Thank you for the opportunity to comment on the SBA 7(a) program.

NATIONAL ASSOOCIATION OF GOVERN-
MENT GUARANTEED LENDERS, INC.
(August 30, 2001)

7(a) Loan Guarantee Fees

Sec. 2. Section 7(a)(18) of the Small Business Act (15 U.S.C. 636(a)(18)) is amended as follows:

(1) by striking from subparagraph (A)(i) "$150,000" and by inserting in lieu thereof "$250,000"; and

(2) by striking from subparagraph (A)(ii) "$150,000" and by inserting in lieu thereof "$250,000".

Sec. 3. Section 7(a)(23) of the Small Business Act (15 U.S.C. 636(a)(23)) is amended by striking from paragraph (A) "0.5 percent" and by inserting in lieu thereof "0.25 percent".

Sec. 4. This Act shall apply to loans approved on or after October 1, 2002.

Explanation

Loans guaranteed under section 7(a) of the Small Business Act require the payment of two fees:

(1) a fee paid by lender but which may be passed-on to the borrower and is based on the amount of the loan:

- 2% on the guaranteed portion if the total loan is $150,000 or less;
- 3% on the guaranteed portion if the total amount of the loan is more than $150,000 but not more than $700,000; and

- 3.5% on the guaranteed portion if the total loan is more than $700,000.

Section 2 of the bill would increase the size of the first tier by $100,000 so that borrowers would pay 2% on the guaranteed portion if the total amount of the loan is $250,000 or less.

(2) an annual fee of .5% (or one-half of one percent) paid by the lender which is prohibited from being passed-on to the borrower.

Section 3 would reduce the amount of this fee to .25% (or one-fourth of one percent).

Section 4 would make these fee changes effective at the beginning of fiscal year 2003 (or October 1, 2002).

Rationale

Since the inception of the 7(a) loan program, the Government has supported small business loan guarantees by appropriating funds to pay a majority of the direct costs of the program while collecting a minority of these costs from program participants. For example, for fiscal year 1995, the government appropriated $195 million which, when added to borrower/lender fees, supported a program level of $7.1 billion at a subsidy rate of 2.75%.

Effective at the beginning of fiscal year 1996, however, the borrower fees were increased substantially and a new fee was imposed on the lender. That year, for the first time, the Government paid a minority of the direct costs and a majority of the cost was borne by borrowers/lenders. That year the Government paid only 1.06% while even the smallest loans (those up to $80,000) paid 2% or twice that amount, while larger borrowers paid up to a maximum rate of up to 3.85% plus a new annual fee of .5% being paid by the lender.

For the current fiscal year, 2001, the government provided an appropriation of $115 million to support $10 billion in 7(a) guarantees at a subsidy rate of 1.17%, with the balance coming from borrower/lender fees.

NAGGL estimates that in fiscal year 1995 (the last year before major fee increases) program participants (borrowers and lenders) paid about one-half of the direct program costs while the Government also paid one-half. This compares with 2001 in which NAGGL estimates that program participants will pay 80% of the cost while the Government will pay only 20%.

In addition, OMB continues to report that it has been overestimating the cost of this program and since 1992 (the implementation of the Credit Reform Act). During fiscal years 1996-2001 reestimates show that the government has collected $1.258 billion more than the program has cost to operate during the past six years. DUE TO THE RATIO BETWEEN FEES AND APPROPRIATIONS DURING THIS TIME FRAME, MOST OF THIS MONEY HAS BEEN PAID BY BORROWERS AND LENDERS. VIEWED ANOTHER WAY, THE GOVERNMENT HAS BEEN OPERATING THE 7(a) PROGRAM AT A SUBSTANTIAL PROFIT DURING THE PAST SIX YEARS DUE TO THE IMPOSITION OF AN UNAUTHORIZED TAX ON 7(a) LOAN BORROWERS AND LENDERS.

We expect OMB to project a cost estimate for the 7(a) loan program at or below zero for fiscal year 2003. This bill, reducing user fees at that time, simply provides that the Government shall continue to pay a very minor share of the cost of the program and thus continue its historic role of supporting small business.

Ms. FORBES. Ms. Calbom.

STATEMENT OF LINDA CALBOM, DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

Ms. CALBOM. My name is Linda Calbom from the General Accounting Office. I also want to introduce Dan Blair. He is the assistant director that has been in charge of our work that we have been doing for both the Senate and House Small Business Committees to take a look at SBA's process for estimating the subsidy cost of the 7(a) program.

Basically, I just want to quickly summarize the results of our work that we issued recently to the Committee. As both the Chairman and Senator Bond said, we found that on a cumulative basis since 1992, defaults have been overestimated by about $2 billion. Recoveries have been overestimated by about $450 million. During the same time the subsidy cost of the program was overestimated by about $958 million, and as the Chairman was mentioning, that primarily relates to the impact of the net overestimate of the defaults.

As far as the recoveries go, we found that most of the overestimate of the recovery simply related to the fact that recoveries are based on a percentage of defaults. So they kind of go hand-in-hand. As far as why defaults were overestimated so much, we really could not tell from 1992 to 1997, because the basis for the subsidy estimates in those years was not very well documented. But for loans that were approved after 1997, SBA has been using a pool of historical data, which goes back to 1986, that they basically average and use as a basis to estimate their defaults.

As everyone has been discussing, loan performance over the last several years has been better than that pool of data back to 1986 would indicate as far as defaults go. This is primarily because the default rates for 1986 through 1990 were extraordinarily high, so that has pushed up the average. We, and others, have been looking at the impact of various alternatives to the subsidy calculation, which would result in a lower default rate than is currently used by SBA. We think that using a lower default rate does makes sense based on the performance over the last several years. However, we do caution somewhat that current economic trends may be less favorable than what we have seen in the last few years. So we just need to be cognizant of that as we make any adjustments to the current approach. Those are pretty much the points I wanted to make and I very much look forward to the discussion.

Chairman KERRY. Thank you, Linda. We will come back to you. I want to pick up on some of the points you made.

Dr. Blanchard.

STATEMENT OF LLOYD BLANCHARD, PH.D. ASSOCIATE DIRECTOR, GENERAL GOVERNMENT PROGRAMS, OFFICE OF MANAGEMENT AND BUDGET, WASHINGTON, D.C.

Dr. BLANCHARD. I am Lloyd Blanchard, Associate Director of OMB. This is my assistant, Jim Boden, who is the branch chief working on small business issues. I want to wish you good morning, Mr. Chairman, Senator Bond and others here at the table. I want to thank you for inviting OMB to share the Administration's views on small business loans.

This Administration believes that the Nation's 25 million small businesses are critical to our success and, therefore, is eager to assist in accessing private sector capital, which they might not otherwise obtain. With a total appropriation of nearly $900 million in fiscal year 2001, the SBA has shown that it can leverage nearly $18 billion in private sector financing through its primary lending and venture capital programs. Under the direction of its new leader, Hector Barreto, the SBA is poised to reach new heights in serving the ever-expanding small business community.

As a new member of this Administration, I look forward to working with Mr. Barreto, Mr. Whitmore—John, excuse me—and his very talented team. I believe that my background as an academic gives me a fresh perspective from which to evaluate these government programs, particularly those that have resource allocation implications. I am charged with and I am excited about taking a leadership role within OMB to assess the accuracy of these credit subsidy models. My experience as a quantitative methodologist and in teaching economics and statistics in graduate schools of public affairs should serve me well in this important task.

I look forward to working with SBA, with the Committee, and with other members within the industry and other interested parties, particularly with GAO, to meet the needs of small businesses. I want you to know that the Administration is sympathetic to your concerns with regard to the accuracy of the subsidy credit model. With that, I will conclude my opening remarks, and I look forward to participating in this roundtable dialog.

Chairman KERRY. Thank you, Dr. Blanchard. I appreciate it.

John.

STATEMENT OF JOHN WHITMORE, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, D.C.

Mr. WHITMORE. Good morning, Mr. Chairman and Members of the Committee. My name is John Whitmore with the Small Business Administration. I am pleased to participate with you today in the roundtable discussion on the Small Business Administration's 7(a) subsidy rate. With me today is Susan Wiles, counselor to Administrator Barreto. There is a new President in the White House and there is a new Administration at SBA. OMB and SBA are highly sensitive to the 7(a) subsidy rate issues that we know have been raised repeatedly over the years by this Committee.

I can assure you there is a new era of cooperation with this Administration that wants to work collaboratively with the Congress and our industry partners to ensure that all small businesses have access to our loan programs. The current 7(a) loan subsidy rate model was developed several years ago with the intent of making it both predictive of future loan performance and stable, so there would be no major swings in the cost of small businesses and the appropriators from year to year. However, there are issues regarding its accuracy.

GAO recently reviewed the 7(a) model, but did not provide specific recommendations to address the issues. However, as we promised in our fiscal year 2002 budget hearing last spring, SBA and

OMB have been working closely together to thoroughly review the current model. Several alternative methods of calculating defaults, recoveries and prepayments are being explored, all having pros and cons. Our goal is to develop a new model that will be reflective of actual performance to date, more predictive of future loan performance and repayment—a degree of stability.

Thank you.

Chairman KERRY. We appreciate it. Those are good encapsulations, and we essentially have, running across the table, as Bruce Phillips has underscored, the importance of small business, the importance of fairness, and the importance of access to credit at fair rates that is going to encourage the growth of small business. Tony Wilkinson has appropriately expressed frustration with the current system, where essentially small business is paying what can properly be deemed a tax, if a fee can be deemed a tax. It is sometimes. We hear that argument around here all the time, well in excess of cost, and therefore is, in effect, subsidizing when it is supposed to be subsidized. Ms. Calbom has documented the situation.

Dr. Blanchard, you articulated sort of the willingness for OMB to think about this, and SBA has been represented in its notion that we need to find a new way to approach this, and that work is ongoing. So the question is—how can we contribute to this dialog, here in this roundtable, in a way that perhaps reaches consensus about the best way to do this, or vets a little bit some of the difficulties with the approaches on the table and the ways to be fair about it.

It seems to me, if you look back in GAO's report, Dr. Blanchard, it says, quote,

> Section 503 of the Federal Credit Reform Act of 1990 states that OMB is responsible for, among other things, reviewing historical data and developing the best possible credit subsidy estimates.

Historical data shows that \$100 million was returned to Treasury in 1996, \$277 million in 1997, \$647 million returned in 1998, \$176 million returned in 1999, and \$513 million returned to Treasury in 2000. It seems on its face that, based on actual performance, those results could not characterize the current model as producing, "the best possible credit subsidy rates." I would assume you would agree with that.

Dr. BLANCHARD. Not necessarily.

Chairman KERRY. OK. Tell us why.

Dr. BLANCHARD. Mr. Chairman, we recognize that the present method that is being used to estimate the credit subsidy rate is limited in its ability to be accurate, to accurately predict the default rates, and therefore credit subsidy rates. We are working to improve that model. We have inherited a model from a previous Administration—not to use that as an excuse—but we are eager to work on this particular model and see if we can improve it.

Chairman KERRY. I agree, but by saying that, aren't you implicitly or explicitly acknowledging that the current model does not reflect an historical review that properly mitigates the cost?

Dr. BLANCHARD. It depends on how you look at the historical views, sir. If you look at as much history as at data allows, then it does. If you look at the history that some in this room I believe think is most relevant, it does not truncate that history in that regard.

Chairman KERRY. When you say history, as far as ability, you are talking about going back to when?

Dr. BLANCHARD. As much data as we have. I believe the data that we have goes back to 1986.

Chairman KERRY. Do you know that? Is that accurate?

Ms. CALBOM. Yes, the data they have goes back to 1986; and just maybe to clarify, we believe the model itself is a pretty good model, but it is the data you put in it that drives the results, and that is the question, is do you—I think that is what Dr. Blanchard is getting at—how far back do you go in the data you use? As I was saying, the 1986, particularly to 1990 timeframe, and getting a little bit into 1991, are real high default rates that kind of skew the averages.

Chairman KERRY. Are not—as you make a model and you take into account sort of best practices—the practices in the 1980's different from the practices today? So to factor in whatever lack of experience, judgment and other safeguards that may have existed in the 1980's into the current model, it seems to me unrealistic. At some point, your model changes based on the degree to which you have become more sophisticated in your implementation of the program. So isn't it more appropriate to measure it against current standards, current practices, et cetera, and current results, simultaneously, which automatically then would suggest measuring all the back data is not a fair way to do it?

Dr. BLANCHARD. I think you make a fair point, Mr. Chairman, and I believe we can make two distinctions. We can use all of the historical data and use the model to represent the different practices and different time periods differently, or we can use some of the data that some believe is more representative of the current practice and use a model that simply treats that data basically the same. I guess what we are here to argue, sir, is that the most appropriate use of this particular model is to use all of the data that is available and weigh it appropriately, given the different best practices across time. We know that there was a major programmatic change in 1992, the preferred lending program, among others, but this is one program that improved the underwriting criteria, which therefore improved the default rate.

Well, as opposed to taking a limited set of data, really on an arbitrary or ad hoc basis, we believe that it is much more appropriate to weigh pre-1992 data differently than post-1992 data, based on some programmatic characteristic that creates the different default rates.

Chairman KERRY. So when do you make the cut? What are you waiting for that is going to be the magic determinative that you talk about?

Dr. BLANCHARD. That is not the only factor. The best practice today in credit subsidy models is, as mentioned by Tony, I believe, is the use of econometric models. Econometric models basically take programmatic factors and economic factors that determine the degree to which those factors contribute to the default rate, and therefore the credit subsidy rate.

Chairman KERRY. Is there any reason, Tony—let me ask you this, building on that. Obviously, the 1990's were different years economically for the country, and when you look at what happened to the market during those years, and the blip for productivity in the country, you might anticipate that, in fact, your returns, defaults, are going to be less than they might be now, let's say, given the current downturn in the economy and what we may see over the next year or two. So should we be making a judgment based on—obviously, those factors have to also come into the best practices applied here; don't they?

Ms. CALBOM. Sure. With the softening of the economy, there is the risk that we could see slightly higher defaults going forward. But to go back into the 1980's—I mean, there have been a lot of changes since then. We have gone from 90-percent guarantees down to 75. We have increased the borrower guaranty fees. We have increased the fees paid by lenders, so not only did they have to take a bigger share of the loan, they also now pay a 50-basis-point ongoing fee. So the financial responsibility of a lender in each of these loans is significantly more today than it used to be.

Chairman KERRY. I want to hear, incidentally, from some of the lenders here about those costs, because that is an important part of this discussion.

Mr. WILKINSON. So the program in the 1980's, it is gone. Today is totally different. Sure, there is something we can learn from history, but last year the agency testified that we were managing this program between an 8- to a 10-percent default rate, and that is exactly where it is. It is in the eights. We might see it move up closer to 9, 9½, but it is not going to be 14, like it is in the 2002 budget request, or 13.87, to be exact.

Chairman KERRY. I am going to yield to Senator Bennett, and I will come back before long and Patty will continue the discussion, if she will.

Senator Bennett, thank you for joining us here.

Senator BENNETT. Thank you, Mr. Chairman. Thank you for doing this. The only other place I have seen this kind of roundtable approach followed was when Senator Gramm did it in the Banking Committee when we were discussing the issue of pooling versus purchase, and frankly it was much more productive than the traditional hearing method, because you had the kind of exchange that I am seeing here. So I congratulate you on doing this and appreciate the opportunity to participate.

I have a little sense of an analogy between what we are talking about here and what happened in the SEC with SEC fees. SEC fees were put in place for the purpose of funding the SEC, and we found that they not only funded the SEC's budget, but they made a fairly significant contribution to the General Treasury, and when those of us on the Banking Committee said it is time to cut the SEC fees back to the level of being sufficient to fund the SEC budget, we found, predictably, from OMB—it was a different OMB—but there is an institutional inertia that gets set in here. We found, predictably, from OMB a resistance to that, because this was a source of funds that they liked.

Dr. Blanchard, I do not want to put you on the spot, but if the surpluses that Chairman Kerry has been talking about continue, would OMB come in and say, “OK, this has turned into a source of funds, this has turned into a tax, and we, in the spirit of the Bush administration that like cutting taxes, say let’s go back to the point where we want no more revenue from this source?” Or are we going to see the same kind of thing we saw with the SEC?

Mr. Wilkinson, isn’t that the basic issue here?

Mr. WILKINSON. Yes, sir, that is exactly it. In fact, the money sent to Treasury this year exceeded our appropriation. I have had some folks draw the conclusion that there may be even an ulterior motive of trying to get the government out of this program. So we appropriate and OMB taketh away in the reestimate process. The number has clearly gotten out of hand, and I am hopeful we can get some movement.

Senator BENNETT. Rather than deal with history, I want to look ahead prospectively. Would the Bush administration say, “We do not want this money to be, in fact, a source of tax revenue. We want it just to cover the default rate and that is it?” If the history continues to demonstrate that the fees are too high, we would support cutting them, just like we did support cutting the death tax, support cutting the income tax rates and the other things that my friend, Mr. Kerry opposed, but I am glad to see him on the same side as the tax cutters in this regard.

Dr. BLANCHARD. Well, Mr. Bennett, the Administration is not prepared at this time to make a policy statement about cutting the subsidy rate. However, we are fully prepared to evaluate the method by which we evaluate and assess these rates. Let me say that we do not believe we use this model as a tax on small business in any sort. Collecting additional revenues through the assessment of fees is not the purpose of the calculation. The purpose of the calculation is to predict the credit subsidy rate that not only shares the risk among the government and the borrowers and lenders, but also creates a self-financing program.

I think the problem that we have run into, sir, is that we have gone through an extraordinary economic time in this country, one of the best economic times we have had in this country in terms of the 8- or 7-year stretch or so. The credit subsidy model will be sensitive, any credit subsidy model or any econometric model that is similar to that will be sensitive to changes in economic conditions. Our ability or anyone’s ability to estimate a credit subsidy rate will be improved by the constancy of the economy, and hurt by the movements in the economy. The economy has been constant of late, but at high level, which has completely, sort of, confounded, I think, past efforts, which is what created the reestimates and extraordinarily high subsidy rates.

However—if I may?

Senator BENNETT. Sure.

Dr. BLANCHARD. Through time, that subsidy rate has been decreased to correct for those overestimates. But apparently, according to history, OMB and others and SBA continue to be confounded by the extraordinary performance in the economy. What we want to do is use a model that represents not only the best of times, but also the worst of times. If we do not have a model that controls for both good and bad times, we will always find ourselves reestimating subsidy rates. So, the corollary to this is, if we use the same model or if we use a model that looks at a limited period of time, which is what I believe that most of the proposals do, then if we move into an economic downturn, we will find ourselves reestimating that subsidy rate upward, just as we had to reestimate these subsidy rates downward in the good times.

Senator BENNETT. Ideologically, I hear agreement and I like that, because I did not hear it when I first came in, the idea being, we do not want this to be a cash cow for the General Treasury. As a matter of principle, we want to be sure that over time in the swings, the number is always zero.

Mr. Wilkinson, do you agree with that, too? Is that where we are? Let me restate it for you. I think I hear now some agreement that says over time we do not want this program to be a cash cow for the Treasury. We want it to be, over time, zero, that it funds the default rate and nothing more. Dr. Blanchard says yes. Do you say yes to that as the ideological goal here?

Mr. WILKINSON. I have not heard him say yes.

Senator BENNETT. He said yes.

Dr. BLANCHARD. We want the reestimates to be zero. We do not want to have to reestimate the subsidy rate.

Senator BENNETT. So that—and I cannot speak for Chairman Kerry, but that is certainly where I would like it to be. So, now we come to this problem. This is not a business where you can set aside money in an accounting category, a reserve for depreciation. This is the Federal Government that operates on a unified budget. In good years it does go into the General Treasury, no matter how obnoxious that may seem, and in bad years it does come out of the General Treasury.

Has anybody done any estimates for the business cycle on the models we are talking about? Because we have not repealed the business cycle. We have discovered that. The present time downturn demonstrates that. No matter how euphoric we got in the 1990's, the business cycle was always there. I tell my constituents when they say, "When are we going to come out of this current mess," I say you can be sure you will come out of this current mess when you have a 100 percent consensus that we are never going to come out. That will be the signal from the economists, the pundits, the New York Times—all say that Bush has pushed us so completely into the ditch that we will never, ever come out. That is the signal that the recovery is underway and vice versa. As the economists were saying in 2000, that we are in a new era and we are never, ever, ever going to see a downturn, that was the signal that the downturn was underway.

So we are not going to repeal the business cycle. It is going to take place. Is there anything on the table from any source, and I am sorry to just be talking to these two, but from anybody else, about a formula that says over time, as it goes up and down and in and out of the business cycle—the net, as agreed by Mr. Wilkinson and Dr. Blanchard, is going to be zero over time? Does anybody know of a model that predicts that kind of result?

Linda, do you want to go ahead?

Ms. CALBOM. I do not know of a model that predicts that, but just to reiterate your point, that I think what you expect to see is things to go up and down. One year you might be above, 1 year below, that over time, like you say, you are trying to get it to smooth out. I think what Dr. Blanchard is saying makes some sense to us, as well. You do not want to just use data that is reflective of the last few years that were really strong years. You want to have some data in there that is going to give you a bit of a cushion, and the chart that is up in various places in the room is actually—it is only showing what various models—how well they would have predicted 1999, which happened to be a very good year.

As you can see, the black line is actually 1999 actuals, which was a very good year. There are various approaches that either give you some cushion or that predict very closely with what happened in a very good year, 1999. In our view, you do not want to be predicting right along on a very good year. You want to allow some cushion, but not as much as we have had on a cumulative basis at this stage.

Mr. WILKINSON. Well, let me just say every time I hear the word cushion, it is a tax, do not forget it.

Ms. CALBOM. But when we say cushion, that is not a cumulative cushion. What we are talking about, when you are looking at a year like 1999, which is a very strong year, then that is a year that some of these models that we have thrown out there, some are above—and that is about as good a year as we have had, and others are just right at it. You want to be somewhere in between is what I am saying. So you are going to have your ups and downs. Does that makes sense?

Senator BENNETT. Yes, but I come back to the ideological point I was making in the beginning, that you want to come as close to zero over time as you possibly can, and everybody agrees to that.

Mr. WILKINSON. If we miss 5 or 10, 15, 20 percent a year, that is one thing. We are missing over 100 percent a year. Use of all this historical data sounds really good, but it has worked horrible in practice. We have very large downward reestimates. We know that we have used default rates in 1999, 2000 and 2001 that are going to be 80 to 90 percent higher than actual performance. So we have got big downward reestimates yet coming in the future. There is something going on here that we just have not got figured out. The bottom line is, 7(a) is not the only credit program in the Federal Government, but it is the only Federal credit program that has got the size of reestimates that we have. What is going on?

Dr. BLANCHARD. Forgive me, Tony. Senator Bennett, I want to address your previous question, with regard to do we know of any models that can achieve the zero reestimate. But before I do that, I want to dispute two claims. No. 1, I think what Linda was referring to with regard to the cushion had more to do with a variance in estimation rather than a cushion with regard to extra money coming into the Treasury. We do not want to use this particular program as a cash cow. We want to use this program for the purposes for which it was designed, which is to help small businesses. So the key is really just to hit the point.

I want to also dispute Tony's claim that the cushion has been over 100 percent. We recognize that over the past 10 or 12 years there is a cumulative $2 billion that has gone back to the Treasury. That total cumulative amount as a percentage of the total loans or even the total appropriations, does not amount nearly to even 10 percent. Last year's reestimate was only $2.6 million. The year before that was $26 million. Yes, going back into time, it goes up, but that sort of scaling down of the reestimate reflects improvement in the quality of the model, but it is not quite there.

The model that will achieve, or at least, that will get closer to achieving what I think we are all interested in is a model that is similar to models that FHA uses, models that are similar to the models that USDA uses and other programs that run major subsidy credit programs, that is econometric models. Econometric models represent the economy in its good and bad times by representing different factors of the economy that tend to drive default behavior. The econometric model represents, and fully represents, in the model, different programmatic changes across time, so that if there is an underwriting change, say in 1992, the data pre-1992 is used just as the data post-1992 is used, but they are weighted differently to reflect different impacts across time on the credit subsidy rate.

That is where we are moving to. So, in theory and in practice, but we are not practicing it yet, the econometric model will achieve that goal. What we are trying to do is move to that point, and it is not an easy task, because it requires very detailed data to represent the different factors in the economy that have that influence on the default rate.

Senator BENNETT. Nobody knows better than I the perils of forecasting. Nobody has a worse track record of forecasting than the U.S. Congress. I am going to be giving a speech on the floor within the next week or two in which I will quote the Congress and President Clinton with respect to the balanced budget agreement entered into in 1997, when we promised proudly and hopefully and with great enthusiasm that the unified budget would come down to zero, therefore balanced, in the year 2002, and that after that period we might even hope for a surplus. Of course, we hit the surplus in 1999, and now this year we are being accused of being in a fiscal ditch when we have the second largest surplus in our history.

So, that shows the perils of economic forecasting with the greatest of enthusiasm and consensus. So I am very sympathetic to the idea that you are constantly looking at the model and you are looking at the factors that are going into it. But the point I want to make, and then I will get out of this, that I want to be sure we leave here, is that everybody agrees that the purpose of the model, whatever it is, is to get the income to the government down to a net zero, in terms of the impact on this program, and that if, indeed, there are flaws in the model, as Mr. Wilkinson would insist, that are causing this to be a cash cow for the General Treasury, those are the first flaws we look at to try to squeeze out as rapidly as possible.

Let the record show everybody is nodding at that, and if I have achieved that kind of agreement, than I better shut up, because that is as much as I am going to accomplish here today.

Did you want to carry forward now for Senator Kerry?

Ms. FORBES. Yes.

Mr. WILKINSON. Can I just make one comment? Not to get hung up on math and numbers, but as Senator Kerry said in his opening statement, since the start of credit reform, we have appropriated about $1.4 billion, already almost $1.3 billion has been returned to Treasury, and we know that 1999, 2000 and 2001 cohorts are going to have big downward reestimates. So by the time we get through, we will have exceeded the appropriation, and that is a 100 percent cushion.

Senator BENNETT. That is a strong indication that some kind of modification is necessary. Just, again, ideologically, as a committed tax cutter—and I think the Bush administration has demonstrated its commitment to tax cutting—that we do want this to turn into a tax, and I do not know anybody around the table who thinks it should be. So let's just leave it at that point.

Mr. WILKINSON. Just so we know, 2002 has got the same big default. It is getting ready to happen again.

Ms. FORBES. I think one of the problems is that the model that they are using—until they change the econometric model, there are going to continue to be these big reestimates. That is what we are trying to get at and trying to see——

Senator BENNETT. That is the reason for the roundtable and amazing bipartisan consensus here in the Committee, that we have got to move to that kind of change as quickly as we can.

Dr. BLANCHARD. Actually, if I may, Ms. Forbes, as each year of data becomes available with the model that we are using, and the GAO can correct me if I am wrong, it improves the quality of the estimate simply because——

Ms. FORBES. But not by enough—the problem is it has been year after year after year that it has been millions of dollars over. That is why we are concerned about it. I agree with you that you cannot predict absolutely to zero, but, on the other hand, the reason this roundtable is happening is there is a big concern that the borrowers and the lenders are paying too much, and; therefore, the credit will not be available to small businesses in a weakening economy. That is why we are having this. So, we understand——

Dr. BLANCHARD. We feel your sense of urgency, yes.

Ms. FORBES. It is great if we can figure out here at this table what a good model would be, but to say we are going to use it eventually is not——

Dr. BLANCHARD. Thank you. We do recognize the sense of urgency in coming up with that model, and we believe—well, what we have done is try to—before we can get to the full-blown econometric model, which I think everyone around the table will agree is the best approach, that requires a significant amount of data, more data than we have available. Until we can get there, what we want to do is use a reasonable middle ground that gets us most of the way or the part of the way there, but we still recognize its limitations.

Ms. FORBES. So what you are saying is that you will probably amend the current model in anticipation of eventually moving to an econometric model?

Dr. BLANCHARD. We are studying various models that will accomplish that goal. We are doing the same thing, essentially, that GAO is doing, which is looking at different models, whether it is a 10-year look-back period or a 5-year look-back period. I have already explained our concerns about truncating the data, because the data represents different time periods which may be extraordinary and not representative of the business cycle in its entirety.

Ms. FORBES. I am going to ask if Senator Wellstone wants to speak now, then we will probably come back to this.

Senator WELLSTONE. I did not say I wanted to speak. I just came in. We had a hearing on stem cell research that I was at and I apologize for being late.

Senator BENNETT. I have got to leave and go to the floor.

Senator WELLSTONE. The only thing I would say, Dr. Blanchard, I am sure you have—and everybody here—I am sure you heard it before, is that the big concern that we have, which I think is what Patty is trying to get at—I just came right in here, but I think I understand the context is—for example, in Minnesota, I would say in the last 5 or 6 years, 7(a)—I think we have leveraged close to $1 billion. This is access to capital for small business. Second of all, we are technically not in recession, but we are near recession. The last thing you want to do is make it more difficult for the small businesses to have access to capital.

I think there are—what I am hearing—I had two SBA hearings back in Minnesota, where the attendance was just astounding. I should have known it would be, but it was much larger than I had anticipated. I am not just trying to spin this. It really was. Clearly, one of the things you are hearing from the lenders, and I think they are saying it in good faith, is we are not the ones who are supposed to be subsidizing this, and between the way in which the subsidy rate has been figured out and the fees that were in the Administration's proposal—I mean, if you want to talk about consensus, there is just a huge consensus that this is not going to work well and could severely undercut small business access to capital. You cannot do anything that you do not think is intellectually honest.

Dr. BLANCHARD. I understand that, but I think there are plenty of questions that we are raising, both about the definition of subsidy based upon default and based upon what has happened with these loans, and the fee part—I just do not understand it for the life of me. I do not understand it. I think it is a big mistake. Didn't we have to go through this with the Clinton administration, too, on the fee part, to be honest about it?

Ms. FORBES. Yes.

Senator WELLSTONE. We did. We had to go through this. So, nobody should take this as a big partisan point here. It is more just advocacy. It is a huge—I think probably this is—I jumped over here from that other meeting, because I would say from Minnesota, I would put this as one of the very top issues right now for our State. I do not need to tell anyone here how important small businesses are, but we are really worried about—unless we get it right with you guys, we are really worried that this flagship program, which has been so important for access to capital, is going to be really greatly weakened.

Dr. BLANCHARD. Sir, if I may respond to at least a portion of your comments—yes, we want to have a model that is consistent in estimating credit subsidy rates, and by consistent, I mean consistent across the government, because we have to evaluate models for various programs, in addition to the 7(a) program. Academic honesty is not the primary goal here. I think we are willing to listen to the concerns of industry, as well as the concerns of the Committee to—and working with GAO and SBA to try to determine what method best serves the needs of small businesses. This Administration does care about small businesses and surely does not put methodology or academic honesty above the needs of small businesses.

Senator WELLSTONE. Real quickly, there is a semantics problem here. I am in academics, so I quickly get defensive about this. What I meant by that, by intellectual honesty is, of course, you are going to be rigorous in your analysis and we want you to be. But we think that some of the projections and some of the methodology is off. We think there should be improvement on the subsidy, and we think the combination of the subsidy and the fees poses a real danger to what has been an incredibly successful program. I cannot imagine the Administration would want to move away from a program that provides small businesses with access to capital. That is what we are saying.

Dr. BLANCHARD. Understood.

Ms. FORBES. I think we should allow some of the other participants here to actually participate.

Senator WELLSTONE. Sorry.

Ms. FORBES. We will get back to the actual model and the timing of when we can hope to have a new model and all the rest of it, but I think most of you have an agenda, I believe, in front of you. If we could hear from some of the other participants about what the effects of these program fees have been on the small businesses that they have been trying to help through loans, and also on their banks' or lenders' willingness to participate in this program, because obviously you cannot have a lending program without lenders. So if you want to speak, just put your card up like this, and I will recognize you.

Yes, David.

Mr. BARTRAM. Thank you very much. Senator, thank you very much for having us here, and I appreciate the opportunity to talk about SBA lending. I am with U.S. Bank. I am an executive vice president for U.S. Bank, and I head up the SBA function for U.S. Bank. We lend in 24 States and we have a $1.5 billion portfolio of SBA loans. So we have been a very active participant in the program. Through the last 5 years, our loans have helped companies with more than 27,000 jobs. So we really believe that we are doing very good work in this area.

However, concurrent with that 5-year period, profits for our company in this program have decreased—37 percent. That is significant because it means the amount of resources that we can use for this loan program—if I could explain, we basically target on a conventional basis perhaps a client base this wide. We use the SBA program now to expand that more to offer terms to clients that might still obtain conventional financing, but with extended terms have more chance to succeed, to employ more people. Then there is still a group further out that could not get conventional financing at all.

What is at risk here with the subsidy rate, for us, and the increased fees that we have seen, both to our clients and to us as a lender, is that risk to help that client base that is out here on the right side.

Dr. Blanchard, you had mentioned that the subsidy rate has come down. The subsidy rate has come down because clients and lenders have paid more fees. That has been what has been driving that down. So we do feel as though we are now providing subsidies for this loan program to go on, and I would certainly urge you to get this fixed as quickly as possible.

Thank you very much.

Ms. FORBES. Mr. McLaughlin.

Mr. MCLAUGHLIN. Thank you for inviting me today, and I appreciate the opportunity to express my opinions on the subject. One of the things that I have not heard this morning about this econometric model is fairness. What is a fair price for a borrower to pay for an SBA loan? To give an example, this year we got a loan for a black family to build a funeral home in a black community, in an area where it is, quite frankly, hard to borrow money. We did the loan. If I may use $250,000—it wound up a little higher than that, as they often do—but there is a reference point. The loan cost for this family to build this funeral home, the SBA costs in themselves, was $6,750. I am not counting identical fees that would apply to both the SBA and conventional loans. This is because they went SBA, their cost was $6,750. The lender's cost on that loan was $3,400.

When you add the total cost of that loan up, it runs about $7,800, almost $7,900 for them to go SBA. This is twice as much—twice the cost as if they could have gone with a regular conventional loan. Now, you say there was obviously not the benefit of the value in a conventional loan that you find in an SBA loan, and one would agree with that, but is the value twice as much?

Say what you want, but the conventional loan market is a reference point that people look at in determining whether they use SBA or whether they do not make the loan, if you will. When you have a disparity, when it gets that wide, it becomes very hard for a lender, No. 1, to justify to the borrower that this is the way you ought to go, and No. 2, when the lender looks at their cost, because recovery on an SBA loan takes about 3 years before we start seeing a profit in it, the lender has to decide whether that is the type of loan product they want to offer.

So I say that in hoping that when you build your econometric model, that the model looks at fairness in the marketplace.

Senator WELLSTONE. I would argue, if I could just real quickly—is it Keith?

Mr. MCLAUGHLIN. Yes.

Senator WELLSTONE. But I would argue that, also built into whether it is an econometric model or whether it is just built into the overall policy question, you get back to the issue of access to capital. That is what this is about. That is what you are talking about. That is what we should be about. One thing, Patty—I was remiss. Perry whispered in my ear—he said you did not mention 504 on the fee part, and I do not know whether or not some of you have experience just on the 504. I would love to hear a little bit about that, as well. I did not mean to slight the 504 program. Anybody on fees and 504?

Mr. WHITMORE. Well, the fee has been at zero for quite awhile now, or the subsidy rate has been zero for quite awhile now, and the actual fees passed on to both borrowers and lenders has dropped over the last couple of years.

Senator WELLSTONE. I am sorry. Could you get over to the mike?

Mr. WHITMORE. The 504 program has had a zero subsidy rate for a number of years now, and the fees were high and have been coming down over the past few years, as a result of improvements in the calculations. So there has been improvement in the program. As we are seeing in the 7(a) program, as well, over time, that we have seen some improvement in the subsidy rates, some, as the gentleman had said, had been attributed to increased cost, but also some had been attributed to improvements in the data and the cycle as each year passes.

Mr. WILKINSON. Could I just add—I am not an expert in the 504 program, but I do understand that they are having the same kind of problems that we are with the default estimates and that they are also having big downward reestimates, as well.

Ms. FORBES. Thank you.

Mr. Stultz.

Mr. STULTZ. Thank you for the opportunity to speak. Just by way of reference, I am not a lender. I make my living helping borrowers get SBA loans and helping lenders get into the SBA loan business and learn the business. Just by way of example, in the 25 years I have been doing this, borrowers were paying a 1-percent guaranty fee when I started. Now it is as high as 3.5 percent. That is a 350-percent increase over what it was, and the demand for loans has not dropped off. The reason is that we are making loans to borrowers who cannot get a loan otherwise. So you can keep raising the fees and they will keep paying them, because they do not have another place to go to get that loan. If they are going to get it, this is the only place to go.

But what has been happening is the profitability to the banks has decreased because of their fees and because of additional burdens put on by the SBA. The program is more sophisticated than it was and it is more involved, and new, young community banks who want to get into the SBA program, frankly, are deciding not to do it now, because it is more complicated and it takes a more sophisticated, expensive staff, and it is a big up-front cost to get into that business.

I am, frankly, seeing banks disappear through acquisitions, but the bank that acquired them deciding not to continue in the SBA business, and the new bank that is thinking about getting into the business looks at what it takes to get into it and opts to do other things instead.

Senator WELLSTONE. You talked about banks. How does that affect the smaller banks versus the larger banks?

Mr. STULTZ. Well, a larger bank has a higher level of bureaucracy to process these things. A small community bank does not have somebody that they can go out and dedicate to doing this full-time instead of——

Senator WELLSTONE. So it makes it harder?

Mr. STULTZ. So it makes it harder for the smaller banks to get into this business and participate. The bottom line is it is harder for the borrower to go out and find a lender who is going to participate in this program and help him get that loan he cannot get otherwise.

Ms. FORBES. Thank you.

Mr. Raffaele.

Mr. RAFFAELE. Yes, thank you. My name is Steve Raffaele, and I am senior vice president and treasurer for Sterling Bank in Houston, Texas, and I very much appreciate the invitation this morning. Sterling is a $2.5 billion publicly-traded bank in Houston, and our culture and our mandate revolves almost exclusively around our commitment to small business. That is what we do and that is everything that we do, down to the lowest levels of our organization. Almost 35 percent of Sterling assets are in small business loans of less than $1 million. You can imagine how many small business loans we have, thousands and thousands.

Virtually our entire commercial loan portfolio is loans less than $2 million, so again evidences our commitment. One of the things that make Sterling unique is that we are involved in the 7(a) program on both the origination and secondary market sides of the fence. So my contribution today would be to add the perspective of treasury and executive management in allocating bank capital to the needs of small business and how SBA and the topics at hand play a mission-critical role in our thinking process.

Investors vote every day on our decisions on how we allocate capital, and the way that they do that is they either buy, sell or hold our stock. So in a very real sense this is what we face when we choose among various opportunities to deploy our resources, opportunities that have now been expanded even further by banking legislation. Fees that we pay related to our 7(a) lending activities have a very visible impact on the returns that we, and ultimately the market, perceive on capital committed, and thus fees have a direct impact on the extent to which we are able to invest in 7(a) lending activities.

In addition, though, to any direct or indirect costs that we might bear as disincentives, there are other critical components, as well, the most critical of which for us is funding, and fundings costs play a role of—it is really the central topic du jour in banking today, and I have not heard much talk about that today. But larger banks—and I want to get back to something that Mr. Stultz said, larger banks have easier access to capital, and I think this answers the question about why smaller banks would have trouble being involved and having an interest in small business lending. Larger banks can get funding for these activities.

So the secondary market for loans and SBA pooling is a critical funding mechanism. However, it does not operate at the same level of efficiency that we see for other classes of lending, for example, consumer loans, mortgages, commercial real estate, bonds, leases; all of these we have a lot of funding opportunities, but for small business we do not. So my encouragement, my hope, is that this Committee, in working with SBA and others, can be a critical instigator of new, higher levels of efficiency in the secondary market by working with the existing resources, technology, willing market participants that might even be willing to bear more of the risk, and potentially even reduce the subsidy rate further than any of us have even anticipated, because they are willing to take that risk if they can get involved in helping us with our funding and ultimately getting more capital to small business.

Ms. FORBES. Thank you. Anything further?

Senator WELLSTONE. No. Thank you everybody. Thank you so much.

Ms. FORBES. Thanks for coming.

Mr. Wise.

Mr. WISE. Thank you for putting this roundtable together and permitting me to be here. My name is Richard Wise. I am president and CEO of American National Bank in Parma, Ohio. It is about a $30 million community bank. I am also chairman of NAGGL, and we have about 700 members nationwide that account for about 80 percent of all the 7(a) loans that are made. There has been some discussion about taking this program to a zero subsidy rate, and we do not believe that is a good idea; that we need to keep some appropriations for this program. It is good public policy, No. 1, and when we do have a downturn in the economy, if the losses do skyrocket, we are going to need some appropriations in order to keep the fees where they are, acceptable.

It is kind of interesting that the Fed has dropped interest rates seven times this year, trying to encourage borrowers to expand their businesses, and there was talk earlier this year about raising the fees on SBA loans. So it is a little bit counterproductive when we have those two features working against each other. My bank is strictly a business bank, has been since 1989. Again, we are a $30 million bank, so we know about all the problems of funding and help and so forth, and we were pretty much an SBA bank up until about 3 years ago.

Our profitability started to just plummet mainly due to the secondary market, the prepays were very high, so the premiums came down, so we started looking for other sources of businesses to do, other than SBA loans. We are doing BNI loans. We did have an offsite meeting in July, and my Board of Directors happened to be 10 entrepreneurs that bought the bank in 1987, I guess. So they are all small business people. At this offsite meeting, it became very evident that the SBA program was not going to be any longer the flagship of our bank, strictly because the profits were not there.

So, again, we are out looking for new products, new sources of revenue from businesspeople that we can do to get our profitability back where we think it ought to be. I do not know how quickly you can repair the subsidy rate to get us down where small businesses again can afford to borrow money using SBA, and that we banks can afford to make those loans without paying a lot of our profits back to the Treasury. I guess we are being taxed as a small business owner at this point in time.

OMB has looked back to 1986 looking for losses. The bank regulators make us go back 3 years to do a 3-year average, and that is how you establish your loss reserve going forward. Hopefully, there is a happy medium there somewhere that—Dr. Blanchard, you can come up with and we will all be happy again. Thank you very much.

Ms. FORBES. Mr. Merski.

Mr. MERSKI. Hi, my name is Paul Merski. I am the chief economist for the Independent Community Bankers of America. We represent about 5,500 banks located around our Nation. As a chief economist for the banking industry, it is very disturbing to see our bankers declining in their use of the 7(a) loan program because of the costly fees, while at the same time the estimates show that the program has paid in over $1 billion into the Treasury. The reason why that is disturbing is I get an opportunity to travel around the country and visit our different small community banks, and get to see the work that they are doing in the 7(a) and 504 lending programs, and actually see the small businesses that are thriving, that they created in the community and created a small economy in their community, that is thriving and paying taxes and doing well. It is unfortunate that they are cutting back on the 7(a) lending because of the high costs to the banks. These banks were operating on very thin margins, as we have heard from some of our other lenders, one to 3 percent profit margin, and a 50 basis point cost on the 7(a) loans makes a big difference to their bottom line and their ability to afford to provide these loans.

As an economist, it is also disturbing to see that when you do econometric modeling, one of the key checks and balances as to whether your model is accurate or not is you plug in the historic numbers and see how accurate they are. If you go back 2 years, 3 years, 5 years, and see that the model is consistently overestimating and providing a subsidy to the Federal Government, instead of to the small business community, that is a failed econometric model.

I just urge that there could be a sensible solution to this constant overestimation, and that these programs, which are so beneficial to the small communities around our country—Senator Wellstone from Minnesota was here, and we have over 300 bank lenders in Minnesota alone that this program could be fixed for and made workable and usable.

One final point is that on several occasions, Chairman Greenspan has addressed our bankers and has encouraged them to increase their lending, and increase their credit to small business, particularly now when interest rates have been cut and the economy is in a slowdown. So, it is ironic that Chairman Greenspan is urging us to increase our lending, yet the costs of these lending programs have been going up while there is a subsidy to the Federal Government. I think there needs to be a solution for this and it is very critical for our small communities around the country.

Ms. FORBES. Thank you.

Mr. Schuster.

Mr. SCHUSTER. Thank you, Ms. Forbes, Mr. Cooksey and your staffs and your members. Thank you very much for the effort that went into this session. I am Deryl Schuster with Businessloan Express, one of the few non-bank lenders still in the program. Several of our peers have departed the program in the last couple of years due to the lack of profitability or the excessive costs in delivering the program, costs of both borrowers and lenders alike. In fact, recently, when one non-bank lender exited the program, they put out a news release telling the world, the stock market, that they were getting off the SBA program and their stock went up.

That is unfortunate and the ramifications truly could be widespread, and I think we need to be concerned about it. But it explains why this meeting is so important, and fixes are even more important. As has been eloquently stated by many small businesses and lenders alike who administer this 7(a) program, they have been unfairly taxed ever since credit reform. The residual benefits of small business and small business loans are well-known; jobs created, tax revenue generated at every level of government. We get no credit for those residual effects. All we get is more and more taxes. It is unfair and it is a tax when we pay more than what the program costs.

If OMB was funding a loan-loss reserve to handle possible increased defaults in future economic shortfalls, that would be different and that would be justified and understandable. But, regrettably, that is not the case. Overpayments just go to Treasury, excess revenue. I can guarantee you if defaults do go up in the future, we will not get one penny's benefit, borrowers and lenders will not get one penny's benefit for the excess revenue or taxes we have paid in the past. It is just truly terribly unfair.

I am reminded that my Administration, just a few months ago, proposed increasing the fees even more, to even exacerbate and magnify the unfairness of the current situation. Fortunately, thank goodness, Congress cooperated by helping to beat that effort down. Something is wrong with this picture.

Let me just conclude by telling you I was asked to bring some examples of the type of gap financing, the type of financing that would not be made were it not for the SBA program and the lenders who pay it. I could have brought hundreds out of our $800 million program, hundreds of appealing examples, but let me just tell you, of the 25 loans we have made to naturalized citizens from Vietnam, people who gave great risk and sacrifice to get themselves and their families to our country, who are now, because of this program, able to participate in the American dream. Every one of those loans exceeded $750,000 as they acquired boats to participate in the shrimping industry, and I might tell you, the loans have performed extremely well. It should go without anybody questioning, without this 7(a) program, these loans, these opportunities to participate in the American dream, would not have happened. Thank you.

Ms. FORBES. Thank you.

Mr. McCracken.

Mr. MCCRACKEN. I am Todd McCracken. I am the president of National Small Business United. I just want to make a couple of very quick points. One is that we have to remember, I think, that the banking community is a very different one than the last time we had an economic downturn in the late 1980's. The number of community banks have traditionally been the primary source of credit and capital for the small business community. So the 7(a) program is far more important as a key lending source for the small business community than it was at that time. It is much larger now than it was at that time. As Tony mentioned before, associations can often play a role of being an early indicator of things that are going on, and we are very clearly hearing, anecdotally, from members some of the very same kinds of signs we saw during the credit crunch period 1989, 1990, 1991.

We think it is crucial that the 7(a) program be in a position to respond to some of those problems, should they really get ramped up. Obviously, there is a confluence of issues here. One is the whole issue of the subsidy rate and the other issue is whatever the subsidy rate is, how much should the government be funding the program versus the fees? Our view, obviously, is that we need to have a realistic subsidy rate. We have to make sure that businesses and lenders are not overpaying to use this program, especially at a time of economic uncertainty that we have right now. But we also have to make sure that the government is playing a role that is appropriate.

If we are entering a time of economic slowdown, it probably is appropriate for there to be some additional funding from the Federal Government, rather than simply fees to pay for some of those increased costs in the 7(a) program. I am not sure if that is on the agenda today, but I think it is an important thing to mention. I feel like the elephant in the room, but those are the gist of my comments. We just cannot forget how different the credit system for small businesses is now than it was the last time we experienced these kinds of difficulties, and 7(a) really has moved to the center as the lender of last resort, that it was not 15 years ago. Thanks.

Ms. FORBES. Thank you.

[The prepared statement of McCracken follows.]

PREPARED STATEMENT OF TODD MCCRACKEN
PRESIDENT OF

NATIONAL SMALL BUSINESS UNITED

Forum Discussion: The Small Business Administration's 7(a) Guaranteed Loan Program

Before the Senate Committee on Small Business and Entrepreneurship

September 5, 2001

Chairman Kerry, Ranking Member Bond, and other Members of the Committee:

My name is Todd McCracken, and I am President of National Small Business United, the nation's oldest bipartisan advocate for small business. NSBU represents over 65,000 small businesses in all fifty states. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. In addition to individual small business owners, the membership of our association includes local, state, and regional small business associations across the country.

I am pleased to appear before the Committee today to share the views of our organization regarding the Small Business Administration's 7(a) Guaranteed Loan Program. Our association is particularly interested in this issue, as access to capital is considered one of our top 10 legislative priorities for the 107th Congress. I'd like to take just a few moments to highlight some of our major concerns.

All small firms, especially those newly established, need a continuous flow of capital to succeed, and traditionally, small businesses have had a difficult time securing necessary investments and loans. As "the lender of last resort," the SBA has had an outstanding track record of funding many firms that have proven to be wildly successful. Any increase in program fees, obviously, would hurt small firms (most of which are operating on very small margins) seeking to establish or strengthen their bottom line.

The General Accounting Office letter released August 21 of this year highlights several concerns with overestimation defaults, recoveries, and the overall cost of the program. The information related to the overestimation of defaults is particularly disturbing, since these defaults go into the calculation of the subsidy rate. The basis of these errors appears to be the current methodology that uses 14-year-old data to estimate defaults. According to our membership, the industry standard for calculation of defaults is actually five years, which is nine years less that the methodology currently being used. Some banks even use four years as a standard.

If the standard that is commonly used by private industry were applied to 7(a) loans, the performance rating would dramatically improve. By using an outdated method, the program is being hamstrung, and most casual observers are not getting an accurate picture of the program's outstanding performance record. Our association has long been an advocate for an even playing field for small business, and this inequity only underscores the need for small business interest to be considered as other groups and concerns are. I would urge the Committee to recommend to the Office of Management and Budget that the 7(a) program default rate be calculated using a five-year approach.

We at NSBU also support full funding for the 7(a) program, and would also ask that the program not be assigned a zero subsidy rate.

I thank the Committee for the opportunity to share just a few thoughts this morning, and I would be pleased to answer any questions any of you may have.

Mr. Ballantine.

Mr. BALLANTINE. Thank you, Patty. This is probably the worst kept secret in Washington as to whether the subsidy rate was off between SBA and OMB, and, from the American Bankers Association, we are simply trying to determine what is the cost and what is the difficulty in getting to this exact subsidy rate, and whether it is lack of information coming from the Small Business Administration or whether there is some misinformation coming from OMB in trying to determine how these two issues merge and how these two parties get together to determine what the correct model should be.

You have mentioned a couple of models; the FHA model and the Agriculture Department has a model, and the loan guaranty program that has been very successful. If those programs, which has been around for years, just as the 7(a) program has been around—has either the GAO or OMB determined that perhaps the Department of Agriculture's subsidy rate calculation model is one that could be used, is best to be used and why, over the years, it has not been used, and whether SBA is lacking funding in putting this model together or not? What is exactly the hold-up here?

Dr. BLANCHARD. Let me just say, Mr. Ballantine, I appreciate your question and it is precisely the question we need to answer. First of all, let me say that I do not think there are differences in what SBA and OMB estimates. I think SBA had a proposal that it was considering at one point as a substitute for the method that is currently being used that OMB sanctions. But we are now in agreement in our efforts to find the best model, to accomplish this goal.

Why can't we get to this, sort of, best practice that USDA and the Department of Education, and their student loan programs, and FHA uses? That best practice is an econometric model that requires a significant amount of data. I do not know why we have not gotten there in the past, but without that data and without that data collection, we cannot represent the factors that drive the default rate. I invite the industry to help us, both OMB and SBA, in putting the data together. The data that is specific for this is the data that drives the default rate, both economic data, as well as programmatic data. With that information, we can be a lot more accurate, and I think GAO will agree with me. We can be a lot more accurate in our ability to estimate the credit subsidy rate.

Short of having that data, we have to use what we have and the best model that we have now. What we are looking at as a substitute for what we have been using, is a model that, although it cannot represent the economic conditions in a rigorous fashion, we do have information on programmatic differences as they have changed across time. We are engaging in an effort to determine the degree to which any programmatic changes, like the preferred lending program that was instituted, I believe, in 1992 or so—the degree to which that programmatic change affected the default rate, and to the degree that it has affected the default rate, it will be represented as such in the revised model.

Let me say that we are continuing to work toward the goal of the econometric model, but it requires data, and we need your help to gather that data and to use it for the purposes of determining an accurate credit subsidy rate. Linda, please help me.

Ms. CALBOM. I cannot make my namecard stand up, so I am having a little technical difficulty. I just wanted to make one quick comment on that as well. Some of the other agencies, they are using pieces of an econometric model, but nobody's really there all the way. In fact, Dan was just pointing out to me, it is kind of interesting, the USDA model, which was just new in the last year, it actually uses some of SBA's data as a proxy for information it does not have, because of this very reason, that they did not have a very good system for accumulating data. So it is a difficult——

Ms. FORBES. Excuse me. Just to clarify, the FHA model only uses it for a small part or two of the elements of who knows how many.

Dr. BLANCHARD. FHA or USDA?

Ms. CALBOM. Both.

Ms. FORBES. I am just trying to show that nobody is using what we are trying to get to eventually, which is fine. It is just that what we are trying to do is find some sort of short-term solution. We are not saying you should not use an econometric model. From what everyone says, it sounds like a good thing. It also sounds like it is going to take quite a while to get there.

So do you have a proposal for the interim? I know GAO has done some studies and has looked at some alternatives. I do not know maybe if Ms. Calbom, if you want to talk to that, or Dr. Blanchard?

Dr. BLANCHARD. Let me just say that OMB is working very closely with SBA to develop a proposal for fiscal year 2003. Right now we are looking at this, sort of, substitute approach, which tries to represent the effect of the programmatic changes that occur across time using all the data. We are beta-testing that model, because we want to run it. As Mr. Merski suggested, we need to test that model by lopping off some data and then seeing the degree to which the model is able to predict the data that we left out. I do not want to get into the weeds on this, but you do that in a systematic way to determine the accuracy of the model. That is what I mean by beta-testing and that beta-testing should be complete by the time we begin to consider the 2003 budget, and I fully expect that we will have something that will be much more accurate than what we have been using before.

Ms. FORBES. I think Mr. Cooksey would like to speak.

Mr. COOKSEY. Just to go back and reflect some on your discussion about your work toward the 2003 budget, to come from my perspective—I work for a Senator from Missouri, the Show Me State, and usually I have to be pretty specific in what I am discussing with him. He usually gets directly to the issue very quickly, and if he were here, he would get very much into the issue. The issue right now to him is 2002, not 2003. I think everyone of us in this room knows that the default rate that is in the 2002 estimate is not going to be hit. We know that 13.87 percent is not reflective of what is going to be the performance of the upcoming model—of the upcoming year.

We know that hours after the close of fiscal year 2002, excessive fees and appropriations that have gone into the financing account will be returned to the Treasury. So for one more year, small business borrowers and banks are going to be taken to the cleaners.

From an academic standpoint, I know, looking toward the econometric model is the way to go. As you said to me earlier, we should have already been there, but to delay providing the kind of relief that we know is available, and we know that can be delivered to small business borrowers and lenders, is a crime.

You said earlier, I think in response to something that Mr. Wilkinson said, Dr. Blanchard, that when, I think, Mr. Wilkinson said that more in fees goes back to the Treasury each year than is appropriated and you responded that that is not necessarily accurate, that while last year—I think you meant for fiscal year 2000—$2.6 million was returned to the Treasury, something like that, which I find just astounding. In a fiscal year which has only been over for a couple hours or days, you are already returning money to the Treasury. It leads me to believe these are excessive fees which you are already returning, and over the course or over the life of that portfolio, that amount, the total amount that is projected to go back to the Treasury will exceed the amount of money that has been appropriated for that cohort.

What I cannot understand is that you say everybody in this room help us, OMB and SBA, improve on the default information. GAO has spent hours, and days and weeks and months working on this. They have delivered to us numerous roadmaps on which to get us out of the fiscal year 2002 problem that is going to start in less than 30 days, ways to use this information that is responsible, ways in which produce the best result that the Federal Credit Reform Act seeks and ways in which none of us could be accused of acting irresponsibly.

Back in 1995, when Senator Bond first became Chairman of this Committee, the first law that came out of this Committee was to increase fees. Tony was here. Deryl was here. All of these other people were here and we made this huge increase in fees, cut the subsidy rate by probably 50 percent, added the 50 basis point fee on all lender loans, put on significant borrowers fees. We did that to increase the size of the program, drive down the subsidy rate and lessen the demand on appropriation.

Do you think all these people in this room who were here then that worked with us in developing these fees that could work would have sat tight if they knew most of this money was going to be going back to the Treasury in excessive fees? No, they would not have gone through that. So we are sitting here and I really cannot understand why an interim program—and I know Senator Bond would be asking you the same question—why an interim reestimate of this plan, when the flaws in the current estimate are so obvious, why a new estimate for fiscal year 2002 cannot be undertaken?

Dr. BLANCHARD. Well, thanks, Mr. Cooksey. I appreciate your comments on that. Let me help you understand that while GAO may have some solutions that can be addressed in the short-term, no solution is going to precisely estimate the credit subsidy rate. Now, we do not know if the default rate will be 13 percent or whatever you said it might be at the end of 2002, but we do not know what it might be. No model, however sophisticated, can be 100 percent accurate. So the question is, what short-term solution gets us where we want to go that is going to be sustainable across time, meaning do we want to have a solution for 2002 and a different one for 2003, and maybe even a different one yet for 2004 and beyond? I do not think that is what we want to do.

That will cause more problems in terms of reestimation and in terms of inconsistency in expectations in the small business community than, I think, the more careful route that we are taking. The more careful route that we are taking is to carefully examine the options that GAO has provided, as well as the options that we prefer. I am not as thoroughly familiar with all of your options and I would be willing to work with you and understand them, but our option is similar to a sort of modified econometric model, which represents those factors that have a direct influence on the default rate, so that we can use the most determinate factors in predicting that which we cannot predict with 100 percent accuracy.

Let me say in closing here that the key principle that underlies the President's approach to financing small business loans for fiscal year 2002, is that the key principle is sharing of risk. Not only does the government share in that risk for guaranteeing the loan up to a certain percent, lenders take on a part of that risk through their commitment in offering the loan, but the borrowers also have to share in that risk. If the borrowers do not share in that risk, they are more likely, or let me say, if the borrowers do not share, financially, in the risk of this program, the default rate is more likely to be higher than if they did have a financial stake in the program.

That being said, the budget did not expect an economic slowdown that recent evidence is now beginning to confirm. We understand that the Senate and the House mark, Mr. Schuster, has recognized the slowdown and has dealt with what many perceive to be our deficiency in addressing your concerns. We are not adverse, given our ongoing study of this program, given the changing economic nature of what we are facing here in the economy, and given the degree to which that change nature impacts small businesses, we are not adverse to deferring to the Senate and House mark on fiscal year 2002.

We are continuing to work on this problem and we will continue to work, both with GAO and SBA, to come up with the best model, the best practice that can be sustainable from 2003 and beyond.

Ms. FORBES. Mr. Brocato.

Mr. BROCATO. Yes, what I would like to talk about is solutions. At this point you have brought up a number of factors that would increase, decrease this on a yearly basis. I think what we really need to focus on is solutions. How are we going to come up with something that can move into effect in the next year, the 12 months? For example, I represent the State of Louisiana, which we had 105 lenders last year. Today, as of last month, we now have 20 lenders in the State that want to lend SBA money. Maybe next year it might just be 10 to 5 lenders. Whatever happens, we have to decide, I would think, in the next 6 to 12 months on what is going to happen, so we do not have a problem 2 years from now when we look around this table and maybe we only have 10 to 15 lenders in each State. At this point would need a major decision, not 6 months or 12 months from now, but something that we can focus on and to try to deliver in the next fiscal year.

Ms. FORBES. Thank you. I do not think there is going to be a lot of sympathy for waiting for the perfect model. I think, as you can see from Senator Kerry's and Senator Bond's amendment to the budget, from the Appropriations Committee finding the money when there was no money in that budget for this program—that was a lot of money for them to find—their strong support for this program in Congress. It is great to get to a better model, a really good model down the road, but let's get to something that works in the interim. We would like to have a commitment, and I am sure Senator Kerry will mention this when he comes back, for all of us to try to work together in the next couple of weeks and try to get something that we can use in the interim. I know people have had there cards up that I saw.

Yes, Tony.

Mr. WILKINSON. Patty, if I could just take charge for just a second, I just want to disagree with Dr. Blanchard on his statement that we probably should not have one model for 2002 and a different one for 2003 and another one for 2004. We have got small business and lenders that are going to be paying more in fees than they have to, starting in about 30 days, and that is what is unfair. Linda said in her opening statement that the model we currently have got is not all that bad. It is the data we are using.

It is clear that a lot of things have happened in this program since the 1980's, a lot of program changes have happened. Yet in our discussions with OMB, they just keep hanging their hat on "we have got to have this business cycle, we have got to have this business cycle," and they forget that we have had improvement in underwriting standards. We now have an Office of Lender Oversight, where lenders are held accountable for their portfolios, and things happen when they make bad decisions, something that we would like to see happen with OMB, too, when they make bad decisions, that they are held accountable for those. But that is another discussion for another day.

But we need something for 2002. It is unfair for the borrowers to be paying more fees than they have do. I do not care if we have got to come up with a new model for 2003. That is great, but it is time to change what we are doing. They can make some very simple default assumptions. What we have is a net present value analysis today. It is not that bad, yet the data that they are putting in there for defaults they know is wrong, we know is wrong. This program is being managed at a default rate in the 8 to 10 percent range. When we have a downturn in the economy, and I will bet you—check me in 5 years—but I bet you it will not go over 10 percent. We know that sitting here today, based on the way the program is being managed, this is not going to go over a 10 percent default rate. It is time to change now.

Ms. FORBES. Ms. Calbom.

Ms. CALBOM. One thing I just wanted to mention—and I do agree that it is more of a data issue. The model itself perhaps is not the big issue, although I also agree eventually we want to get to an econometric model. But Technical Release 3, which is guidance for preparing credit subsidy estimates—it was put out by the Accounting and Auditing Policy Committee—it says very clearly that you use historical data adjusted for changes in economic or programmatic conditions, and I think that is what we are facing here, and we need to be flexible in doing that, and we need to be able to do that quickly, because programmatic and economic conditions change quickly.

An econometric model does that for you. But in the interim, we need to be willing to do that, and that is why we have kind of looked at some different proposals where we have said let's adjust for the fact that lending practices have changed, let's adjust for the fact that the economy has changed. Let's also not forget that the economy may be changing again soon. So you need to take those factors into consideration, but the point is you need to be flexible and adjust as changes occur.

Dr. BLANCHARD. Mr. Chairman, I do not disagree with what Linda just said, except that the data is not necessarily the problem. I believe the comment was it is not the model that is the problem, it is the data. But we are forced to work with the data. We are forced to work with historical representations of default rates and economic conditions. We will work to improve that data, but the data must be used.

Chairman KERRY. When will you work to improve this?

Dr. BLANCHARD. We are now.

Chairman KERRY. Yes, but you see—I know Mr. Cooksey raised this issue, and I was going to raise this toward the end, anyway. I think the timing here is really critical. There is a sense among the community that there has been a kind of stiff arm for awhile. This has been a delay process—we will put it out there, let it hang out there, but we get through this budget and we get through the next budget cycle. Meanwhile, over $100 million is inappropriately sucked out of the small business community, annualized, or $250 million or $600 million in a particular year.

I do not think you are going to see the $600 million this next year, but you certainly are likely to see a continuation of these significant amounts. It is beyond my comprehension, frankly, Doctor, why it is not possible for OMB to sit there and say, "You are correct, this is inappropriate; this is not stimulative." It is, in fact, not even good counter-cyclical policy for the moment you find yourselves in. The engine that you are looking for to move the economy is not going to be helped by keeping these stiff fees where people like Mr. Wise and others make the comment that the Fed is coming down, down, down, and here you guys are going up. It does not make sense.

I fail to understand why it is not possible to make adjustments, if you put your mind to it, if you want to do it, you can find the people that have good common sense around this table and elsewhere to come up with a model that tries to adjust. If you miss it in the first year—we are all working together at this effort—so we can adjust at the end of that year and bring it back. But to sit there with something that has got 6 or 7 straight years of out-of-whack disequilibria is unacceptable, just unacceptable.

Dr. BLANCHARD. I appreciate your concern, sir. The history of this program is one that has had an unfortunate one. The Administration is working in its first year to correct this problem, and it is one that we inherited that, as you all have mentioned, is a significant problem.

Chairman KERRY. We have had 5½ months now, 5 months with the Administration aware of this, with a budget that was already rejected by this Committee, overwhelmingly. If there is not a message in that, I do not know what the message is.

Dr. BLANCHARD. That message was heard loud and clear, sir.

Chairman KERRY. But why is it that this message was not responded to equally? Why is it impossible to put this into the current budget? I do not understand that, particularly given the needs of small business. I would think you guys would want to be doing this, that this is the best way possible to help small businesses in this country.

Dr. BLANCHARD. I mentioned earlier, before you walked in the room, Mr. Chairman, that given the economic downturn that has been confirmed by recent evidence, given the concerns that are raised here and that have been raised, given the fact that we are working on a model that will best serve our needs and serves as the best practice for estimating the subsidy rate, that we are not likely to be adverse to deferring to the message that was sent by this Committee loud and clearly.

Chairman KERRY. Which one, the message about the budget or the message about the formula?

Dr. BLANCHARD. The message about the budget.

Chairman KERRY. What about the formula?

Dr. BLANCHARD. The formula that is used to estimate the rate for fiscal year 2002, by law, by the Credit Reform Act, has to be based on the assumptions built into the fiscal year 2002 budget. Those assumptions cannot be changed.

Chairman KERRY. It is not possible to come up with a different model?

Dr. BLANCHARD. We can come up with a different model, but the model is driven by the assumptions.

Chairman KERRY. Which assumptions are driving the fact that you have to have a surplus of—what was the last one, last year?

Mr. WILKINSON. One hundred and seventeen million last year.

Dr. BLANCHARD. I cannot tell you the precise assumptions, sir. I apologize, but——

Chairman KERRY. Why can't those assumptions be changed? Look, we just voted on a budget a few months ago. I voted against it because the assumptions were wrong, and now they have been proven to be wrong, and there were divergent assumptions between CBO and OMB. CBO had a very different set of assumptions, and they do again right now.

Dr. BLANCHARD. We are bound by law to maintain those assumptions, in terms of the implementation of credit subsidy models. But as I said, the message that was sent by this Committee with regard to the funding, the appropriation for SBA, is one that we will surely consider, is one that we will likely defer to.

Chairman KERRY. Dr. Blanchard, let me ask you something. Are you telling me that if there is an error in an assumption, you are legally bound to adhere to the error?

Dr. BLANCHARD. No, I am not saying that there is an error in the assumption, sir.

Chairman KERRY. I can tell you, you are not, and it seems to me patently clear there is an error in the assumptions.

Dr. BLANCHARD. I do not believe we read it that way, sir.

Chairman KERRY. Well, how do you justify the surplus? How do you justify the excess subsidy if there is not an error? Clearly, it is not correct because it is not balancing out or close to the equilibrium that it was supposed to be at. I do not understand that. How do you justify that?

Dr. BLANCHARD. Our lack of ability to estimate economic conditions, and by our, I mean not only the Administration's ability, but any organization who makes that assumption.

Chairman KERRY. If you have 6 or 7 years of—let me see now—213—excuse me. Yes, the re-estimate, 100, 277, it began in what? 1995, 1996, $100 million, $277 million, $647 million, $176 million, $100 million. So for 5 years, there has not been one reestimate under $100 millon. One might think it was reasonable to find a formula change that took $100 million off the cost and see where you wind up at the end of the next year, if there was a reasonable effort to be fair. By any reasonable person's standard, it is very hard to assume where the fairness is here, if you have had 5 straight years of over $100 million excess, why you do not adjust that is beyond me.

Dr. BLANCHARD. We are adjusting this model consistently across time. I cannot explain the past errors in estimation. I can say that it seems, through the trends set, the sort of downward trending of the subsidy rate itself, it suggests that the improvement, at least institutionally within SBA and within OMB, has taken place, and we will continue that improvement.

Chairman KERRY. What do you say to that, Ms. Calbom?

Ms. CALBOM. Our feeling is that there is some room for adjustment. Again, kind of going back to this graph, I think we want to be a little bit careful not to adjust, so that we are tracking the last few years, which have been very, very strong years. I think you can use that as a starting point, perhaps, but at the same time I think there is room to come down from where we have been.

Chairman KERRY. I am wondering whether we should legislate a rebate structure so that at the end of the year, you have to hold whatever is in excess in escrow, and at the end of the year all users are prorated a rebate.

Dr. BLANCHARD. That would surely make everyone in this room very happy.

Chairman KERRY. Would it make you happy?

Dr. BLANCHARD. I would not personally have a problem with it, sir. Whether or not the Administration will support that effort, I cannot commit to that.

Chairman KERRY. You mean whether or not they need that to cover other expenses?

Dr. BLANCHARD. That is nothing I will commit to right now, in terms of support, sir. But it is a fascinating and interesting proposal.

Chairman KERRY. The question here is whether or not the small business lending program, which is supposed to make credit available at a reasonable price, has over charged fees to borrowers and lenders that are getting to the point where they say this is no longer a flagship program. It seems to me that if you could equalize that, rather than see that money used—effectively, you are asking those small businesses to subsidize other expenses of the Administration, including the tax cut, I might add. It is effectively a wealth transfer. We are taking from small businesses, and we are giving it to the folks who are getting the tax cut at the other end, because that is what it is used for.

Dr. BLANCHARD. That is not our purpose.

Chairman KERRY. That is the effect.

Dr. BLANCHARD. That is not the purpose in the way we operate the SBA program.

Chairman KERRY. If we cannot get you to change the model itself, we ought to at least guarantee that at the end of the year— it is like the FHA program. We run into this, too. The FHA insurance program runs a $5 billion surplus annually, at a time when we are cutting housing. Housing is producing a surplus, but does housing get the surplus? No. It goes into general revenue and helps cover all these other things people do. It is unconscionable, I have got to tell you. It is bad public policy. It may be good bookkeeping, but it is bad public policy.

Dr. BLANCHARD. I tend to agree with you there, sir.

Chairman KERRY. What do you say there, Mr. Wilkinson, as to where we find ourselves in this discussion? Is there a way through it, in your judgment?

Mr. WILKINSON. I am hopeful that the message has been heard loud and clear, that there is a significant problem that has got to be dealt with and dealt with quickly. I am concerned about the response from OMB today, that they want to hesitate and defer and push it off into the future while we continue to charge borrowers who are closing loans today and tomorrow fees that do not need to be charged, concerned that we continue to hear OMB say the problem with the model is our lack of ability to make economic predictions, and they totally overlook how the program has been changed from its structure inside, with lender participation and fee structures and all the things that we have done in improving the underwriting standards over the last decade, totally ignored.

Chairman KERRY. Well, I am sympathetic to that notion. Look, obviously, we do not want to go back to the days where it is running on the other side. You do not want to put the government excessively at risk for defaults. I would be disingenuous if I did not sit here and suggest that these numbers raise the specter of whether or not that 5-year bubble of overpayments does not have something to do with the 5-year economic bubble we have just gone through. So you want to be somewhat cautious and thoughtful here so that you do not set yourselves up for a fall. I do not think we should do that. We ought to be smart. So maybe the best way to do it is to at least hold people harmless at the back end.

Maybe the idea of this rebate thing is not off the wall, which covers the potential of a downturn, a disaster. But in the end, the businesses are insuring themselves against that, and there is a rebate appropriately directed according to cost. It seems to me that might not be a bad way to think about it, at any rate, as a way out of this, so that the government is protected, but at the same time people are not gouged. Any comment, response, thoughts?

Dr. BLANCHARD. I would just say that we recognize the limitation, and to beat a dead horse, we are continuing to work on this, and we believe that we have a short-term solution. However, the implementation of that short-term solution in fiscal year 2002 may be limited, and that limitation compels—may well compel the Administration to defer to the House and Senate mark with regard to the SBA appropriations. But we are eager to continue to work with the Committee, to work with the industry——

Chairman KERRY. Doctor, is there any way we can put that on a schedule? Could we get some timetables here, and perhaps accelerate the process? Is there any reason we could not anticipate a reconvening of this in number of weeks, to reevaluate where you come out in your judgments on the issue that we just talked about?

Dr. BLANCHARD. I will have to check with my general counsel, sir, but my understanding of the implementation of the program is that it is based—it must be based on the assumptions built into the President's budget submission for that fiscal year. So any changes to the current subsidy model for fiscal year 2002 must require changes to the President's fiscal year 2002 budget submission.

Chairman KERRY. You are saying that the model is linked inexorably to each of the assumptions?

Dr. BLANCHARD. As per the——

Mr. WILKINSON. Mr. Chairman, could I just add that one of the assumptions in the model is an estimate of interest rates. At the time they did their budget request, they estimated a 5.1 percent discount rate that would be used in the model. In fact, come October 1, they are going to go look and see what the actual rates are on the day, and they are going to change that model. Rates have come down, our subsidy rate is going to go up. So they are going to change based on actual data coming up in about 3 weeks. It happens every year.

Chairman KERRY. And raise the subsidy?

Mr. WILKINSON. This will raise the subsidy rate, because the discount rate has fallen.

Chairman KERRY. It seems to me if you can do that in a few weeks, why can't you do the other?

Dr. BLANCHARD. Pardon?

Chairman KERRY. I do not see how you can pick and choose which ones you do.

Dr. BLANCHARD. I am not sure that I agree with Mr. Wilkinson's assessment of the change. There may be a review that looks at that discount rate, but I doubt that change can be applied in 2002.

Mr. WILKINSON. Yes, it can. The subsidy rate changes, I would have to go look, but I will bet the final subsidy rate on October 1 has not been the same as the subsidy rate in the budget for quite some time. It is off by one or two basis points one way or the other.

Ms. CALBOM. Just one quick comment or, I guess, question that I had; the default rate, though, is not any assumption that is built into the President's budget; is that correct?

Mr. BODEN. It is primarily the discount rate that is used. That is the one that has to be used in the President's budget, and, as Mr. Wilkinson said, at the end of the year that discount rate will be adjusted for actuals that have taken place during the year.

Ms. CALBOM. But the default rate, I think, is more what we are talking about.

Chairman KERRY. Why can't the default rate be adjusted?

Dr. BLANCHARD. The default rate would be adjusted if the discount rate is adjusted. Am I correct, David?

Mr. BODEN. [No response.]

Chairman KERRY. I do not want to leave this—it may well be that we do not have a return here. We have got a few weeks here left to work on this Budget. We are going to have a continuing resolution probably for the short-term, because we are not going to get all of these approps done. I would like to figure this out. I would like to get some timetables here. So what I would like to do is ask you if you would go back, and if I need to call Mitch Daniels, well, we will do that, and see if we cannot get some focus on this issue. I would like it not to be confrontational. This is not a Democrat-Republican issue at all. This is a bipartisan effort. Senator Bond, myself, and other members of the Committee are trying to figure out how we are going to make it more reasonable and fair for small businesses, which is in all of our interests, to have access to affordable credit.

I think it is in our interest for all of us to try to work together to do it. If you could go back and review, Dr. Blanchard, what your understanding, what counsel's understanding is specifically, I would like a very specific response back to us about what, if any, limitations exist on our ability to change the default assumptions in the Budget. That is No. 1. No. 2, I would like to know specifically what ways you propose to solve the inaccurate subsidy rate estimates. I am going to ask for this also from the SBA—John, would you and the Administrator tackle this? Mr. Wilkinson and to GAO, to come up with a common understanding of what the possibility is. I would like to have that report back in about 3 weeks. That is ample time, it seems to me. Then we will make a decision whether we reconvene the roundtable or have a meeting or have a hearing, to review how we might proceed to try to address this, if possible. Meanwhile, staff—nothing should restrain our staffs from kind of cranking out on this. If we can, see if we can come to some mutual agreement. Does that make sense?

Dr. BLANCHARD. It makes perfect sense, sir. We believe that this does not have to be an adversarial process, either, and OMB stands ready to commit to providing you with that information. I cannot speak for GAO or SBA.

Chairman KERRY. As I say to you, none of us here—we have worked hard over the last 15 years on this Committee to shore up this program. Where there were weaknesses, we tried to address them, and there were some. There have been some, and it may well be that after a decade of plenty, as the pressures mount, there clearly are going to be some casualties out there. No question about it. I think we would be responsible if we did not recognize that we have got to not only look at bringing new people in, but we have also got to nurture what we have there and be smart about it. So there is a balance. I just think it is inappropriate for those small businesses to be funding a whole lot of other things in government, which is effectively a back-door tax, and I want to find a way to free them from that burden. I hope we can work together to do that. Fair enough?

Are there any other comments anybody wants to make? Yes, sir?

Mr. WISE. I have a question. I heard that OTC had done a report on SBA loans. Do you know anything about that?

Mr. WHITMORE. I do not. I believe there was a study done, and I have not looked at it.

Mr. WISE. It would be important to see that study.

Chairman KERRY. We will get a hold of it.

Mr. WISE. I have talked to my folks, and they know nothing about it.

Chairman KERRY. We will take a look at it. We will do it.

Mr. WILKINSON. We submitted a written statement. Could we include that in the record, please?

Chairman KERRY. All written statements will be placed in the record in full as if read, and they will be part of the record. I look forward to following up on this in 3 weeks, if we can. Hopefully, we could even come to some agreements or some thoughts about it ahead of time; that would be helpful. We stand adjourned. Thank you all very much.

[Whereupon, at 11:58 a.m., the Committee was adjourned.]

APPENDIX MATERIAL SUBMITTED

IIB

107TH CONGRESS
1ST SESSION

H. R. 2590

IN THE SENATE OF THE UNITED STATES

JULY 26, 2001

Received; read twice and referred to the Committee on Appropriations

AN ACT

Making appropriations for the Treasury Department, the United States Postal Service, the Executive Office of the President, and certain Independent Agencies, for the fiscal year ending September 30, 2002, and for other purposes.

apply to printed hearings released by the Committees on Appropriations or the Committees on Veterans' Affairs: *Provided further*, That none of the funds appropriated in this Act may be available to pay the salary or expenses of any employee of the Office of Management and Budget who calculates, prepares, or approves any tabular or other material that proposes the sub-allocation of budget authority or outlays by the Committees on Appropriations among their subcommittees: *Provided further*, That of the amounts appropriated, not to exceed $6,331,000 shall be available to the Office of Information and Regulatory Affairs, of which $1,582,750 shall not be obligated until the Office of Management and Budget submits a report to the House Committee on Appropriations that provides an assessment of the total costs of implementing Executive Order No. 13166: *Provided further*, That the Housing, Treasury and Finance Division shall, in consultation with the Small Business Administration, develop subsidy cost estimates for the 7(a) General Business Loan Program and the 504 Certified Development Company loan program which track the actual default experience in those programs since the implementation of the Credit Reform Act of 1992: *Provided further*, That these subsidy estimates shall be included in the President's fiscal year 2003 budget submission and the Office of Management and

Budget shall report on the progress of the development of these estimates to the House Committee on Appropriations and the House Committee on Small Business prior to the submission of the President's fiscal year 2003 budget.

OFFICE OF NATIONAL DRUG CONTROL POLICY

SALARIES AND EXPENSES

(INCLUDING TRANSFER OF FUNDS)

For necessary expenses of the Office of National Drug Control Policy; for research activities pursuant to the Office of National Drug Control Policy Reauthorization Act of 1998 (21 U.S.C. 1701 et seq.); not to exceed $12,000 for official reception and representation expenses; and for participation in joint projects or in the provision of services on matters of mutual interest with nonprofit, research, or public organizations or agencies, with or without reimbursement, $25,267,000; of which $2,350,000 shall remain available until expended, consisting of $1,350,000 for policy research and evaluation, and $1,000,000 for the National Alliance for Model State Drug Laws: *Provided*, That the Office is authorized to accept, hold, administer, and utilize gifts, both real and personal, public and private, without fiscal year limitation, for the purpose of aiding or facilitating the work of the Office.

Congress of the United States
Washington, DC 20515

May 4, 2001

The Honorable David M. Walker
Comptroller General
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Walker:

The 7(a) Business Loan Program is the largest loan guarantee program at the Small Business Administration (SBA). It is the primary vehicle for providing small business borrowers with access to long-term commercial credit. Under the Federal Credit Reform Act of 1990, the 7(a) program, as well as other Federal guaranteed loan programs, receives a credit subsidy made from an appropriation to cover the expected losses to the Federal government from the loans it guarantees. Each fiscal year, Federal agencies offering loan guarantee programs calculate the estimated subsidy costs, known as subsidy rates, for budget and financial reporting purposes. Federal agencies operating loan guarantee programs are also required to submit annual re-estimates of subsidy rate costs for loans guaranteed in Fiscal Year 1992 and later. The re-estimates are to adjust the original subsidy cost estimates based on actual loan performance.

Over the past decade, it appears that the subsidy rate estimate calculations from the SBA and the Office of Management and Budget (OMB) for the 7(a) program have significantly overestimated loan default rates, which, consequently, have inflated credit subsidy requirements. In other words, the overestimates have made the program more expensive to fund than is actually necessary to cover its true cost, and the direct impact has been to force Congress to appropriate more funding than is necessary and the small business owners and lenders to pay higher fees than are necessary.

We are requesting that the General Accounting Office (GAO) analyze SBA's 7(a) subsidy rate calculations to assess the level of difference between the projected cost and actual cost. Specifically, we ask that the GAO assess the estimated default and recovery rates and the timing of these events used in the subsidy rate calculations against actual defaults and recoveries recorded in SBA's accounting system.

Additionally, we request that the GAO analyze the process used by the SBA to estimate the defaults and recoveries for the 7(a) program including the amount and type of data used and the SBA's method of calculating average losses and recoveries. Please discuss how the SBA incorporated changes in program design in making these key cash-flow assumptions during this

The Honorable David M. Walker
Page 2

period. We would be particularly interested, as this year's appropriations process proceeds, in GAO's findings as to whether the methods used by the SBA for estimating defaults and recovery rates are reasonable in light of the 7(a) program's actual performance, and, if they are not reasonable, what can be done to improve or fix the method. Ultimately, we would like to know the cause, or causes for the differences between estimated and actual defaults and recoveries and the corresponding solutions. Consequently, your insight into possible solutions that could be developed to make the credit subsidy estimates more accurate would be very helpful.

The President's Fiscal Year 2002 budget request for the SBA includes a credit subsidy estimate of 1.07%. In order that our Committees can evaluate this request in a timely manner and make recommendations to our respective Appropriations Committees, we ask that you deliver your findings to the Senate and House Committees on Small Business no later than July 27, 2001. In the interim, we request periodic briefings to our Committee staffs as you proceed with the examination of the credit subsidy rate estimates for the 7(a) program.

Thank you for you prompt attention to our request.

Sincerely,

John F. Kerry
Ranking Minority Member
Senate Committee on Small Business

Christopher S. Bond
Chairman
Senate Committee on Small Business

Nydia M. Velázquez
Ranking Minority Member
House Committee on Small Business

Donald A. Manzullo
Chairman
House Committee on Small Business

GAO
Accountability * Integrity * Reliability
United States General Accounting Office
Washington, DC 20548

August 21, 2001

The Honorable John F. Kerry
Chairman
The Honorable Christopher S. Bond
Ranking Minority Member
Committee on Small Business
United States Senate

The Honorable Donald A. Manzullo
Chairman
The Honorable Nydia M. Velazquez
Ranking Minority Member
Committee on Small Business
House of Representatives

Subject: Small Business Administration: Section 7(a) General Business Loans Credit Subsidy Estimates

In your May 4, 2001, letter, you expressed concerns about the Small Business Administration's (SBA) 7(a) Business Loan Program subsidy rate calculations. As agreed with the staff of your committees, we reviewed the subsidy rate estimation process and the data SBA uses in its calculation, with a specific focus on defaults and recoveries. We identified differences between originally estimated defaults and recoveries and actual data, and the causes of these differences. Additionally, we assessed the implications of proposed changes to SBA's current approach to estimate defaults. On July 30, 2001, we briefed your staff on the results of our review. This letter transmits the material from the briefing.

In summary, the process and types of data SBA uses to estimate the subsidy cost of the 7(a) program are generally reasonable and comply with existing Office of Management and Budget (OMB) guidance. However, our review of actual and originally estimated defaults and recoveries showed that, on a cumulative basis since 1992, defaults were overestimated by approximately $2 billion and recoveries were overestimated by approximately $450 million.[1] During this same period, SBA overestimated the cost of the 7(a) program by $958 million as evidenced from a trend

[1]Because SBA calculates estimated recoveries as a percent of estimated defaults, most of the overstated recoveries resulted from the initial overestimate of defaults. When recoveries were calculated independent of the default overestimate, the cumulative overstatement of recoveries was less than 1 percent of actual recoveries, or about $3 million.

of downward reestimates.[2] The majority of these downward reestimates can be attributed to the overestimate of defaults.

For those loan guarantees approved from 1992 through 1997, we were unable to determine the specific reason for the overestimate of defaults primarily because the basis SBA used for the estimated default rate for these years was not documented.[3] Reestimates during this period account for approximately 84 percent of the total $958 million reestimate. SBA began using its current methodology in 1998. This methodology uses average historical data since 1986 to estimate defaults. Under this method, high default rates associated with loan guarantees approved in fiscal years 1986 through 1990 contributed to the difference between estimated and actual defaults for loan guarantees approved from 1998 through 2000.

SBA has proposed to OMB another methodology that uses the 5 most recent years of actual loan performance prior to each activity year being estimated—referred to as the lookback period[4]—rather than the current approach that uses all actual loan performance since 1986, to estimate loan performance for each activity year. OMB is currently considering this proposal. Either approach has certain benefits and inherent risks.

Under the current approach, initial estimates of the subsidy rate are fairly stable because they include more years of historical data that smooth out fluctuations in economic conditions from year to year. As previously mentioned, the current approach includes several early years with relatively high default rates. A benefit of this approach, given SBA's historical experience, is that it provides a cushion in the event of an unexpected downturn in the economy. However, this cushion ties up appropriations that could have been available to other discretionary programs. As has recently been the case for SBA, this approach is more likely to result in continuing annual downward reestimates when there is a strong economic environment.

The proposed method would be more sensitive to fluctuations in economic conditions or changes in program delivery or design because it uses a shorter lookback period. The benefit of this approach is that, in a continuing stable economy, the original subsidy cost estimate would be expected to more closely match actual loan performance and reestimates would therefore be smaller. However, the risk of this approach is that a sudden downturn in the economy would be much more likely

[2]In addition to the differences between actuals and estimates to date, the total downward reestimate would also be affected by the present value of these differences and changes in the estimates for expected future loan performance.

[3]According to SBA officials, prior to the estimate of the 1998 cohort's subsidy cost in fiscal year 1996, subsidy cost estimates were prepared based on direct consultation with OMB.

[4]For example, under the 5 year lookback period, the 2002 cohort estimate of year one default activity would be based on the average actual first year defaults that occurred for the 1996 through 2000 cohorts and the second year default activity would be based on actual second year defaults that occurred for the 1995 through 1999 cohorts. Under the current approach, the lookback for all activity years includes the average of all cohorts back to 1986.

to result in actual loan performance being different than estimated and thus would likely result in larger upward reestimates than under the current approach.

SBA generally agreed with the information presented in this briefing. SBA officials added, however, that they view the proposed changes in default estimation methodology to be an interim solution. SBA views the long-term solution as a sophisticated econometric modeling approach. Econometric modeling considers key relationships between loan performance and economic and other indicators.

We are sending copies of this letter to the Administrator of the Small Business Administration and the Director of the Office of Management and Budget. This letter will also be available on GAO's homepage at http://www.gao.gov.

If you have any questions, please contact me at (202) 512-9508 or by e-mail at calboml@gao.gov, or contact Dan Blair, Assistant Director, at (202) 512-9401 or by email at blaird@gao.gov. Key contributors to this letter were Marcia Carlsen, Ruth Sessions, and Bill Shear.

Linda M. Calbom

Linda M. Calbom
Director
Financial Management and Assurance

Enclosure

Enclosure

Briefing Before the Staffs of the Senate and House Committees on Small Business

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Briefing to Staff of the Senate and House Committees on Small Business

Small Business Administration

Section 7(a) General Business Loans Credit Subsidy Estimates

July 30, 2001

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Contents

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- Effect of Overestimating the 7(a) Program's Subsidy Cost
- Causes of Differences
- Implications of Proposed Changes
- Agency Comments

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Objectives

Our objectives for the Section 7(a) General Business Loans (the 7(a) program) review were to

- identify the types of data and process used to estimate the subsidy cost, including the incorporation of program changes,
- compare originally estimated defaults and recoveries from the 1992 through 2000 subsidy cost estimates to actual data recorded in the accounting system,
- determine the causes of differences between original estimates and actual defaults and recoveries,
- assess the implications of proposed changes to SBA's approach to estimate defaults.

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Scope and Methodology

- To achieve our objectives, we
  - discussed SBA's process and types of data used to prepare subsidy cost estimates with agency staff,
  - compared SBA's current process to prepare subsidy cost estimates to existing guidance from the Office of Management and Budget (OMB),
  - reconciled actual data used as a basis to estimate defaults and recoveries with data from the accounting system,[1]
  - analyzed trends in the actual defaults, recoveries and guaranteed percentages,

[1] We were not able to reconcile to the actual data prior to fiscal year 1992 because the current accounting system was implemented in 1992 and does not include data prior to that time.

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Scope and Methodology

- compared the original estimated default and recovery amounts for the 1992 through 2000 cohorts[2] to actual loan performance data recorded in the accounting system,
- discussed the causes of differences and proposed changes with SBA staff and OMB officials, and
- determined the potential impact of various alternative approaches on subsidy cost estimates.

- Our audit work was conducted in Washington, D.C., from May 2001 through July 2001 in accordance with generally accepted government auditing standards.

[2] A cohort includes those direct loans or loan guarantees of a program for which a subsidy appropriation is provided for in a given fiscal year even if the loans are not disbursed until subsequent years.

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Background

- The 7(a) program guarantees loans made to small businesses that are unable to obtain financing on similar terms in the private credit market but can demonstrate the ability to repay the loan.
    - SBA reported that its share of outstanding 7(a) loan guarantees totaled nearly $22.9 billion as of September 30, 2000. This represents about 65 percent of SBA's total loan guarantees outstanding.
    - From 1995 to 1996, SBA undertook a significant data gathering effort to capture historical loan performance for the 7(a) loan program and began using this data in 1996 to estimate the subsidy cost of the 1998 cohort.

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Background

- Since the inception of credit reform, the 7(a) program has had net downward reestimates of nearly $1 billion.[3]

    - In March 2001, SBA submitted a proposal to OMB, which is discussed later in more detail, to adjust its approach to estimating the subsidy cost of the 7(a) program.

    - OMB is in the process of reviewing the recent SBA proposal.

[3] A downward reestimate indicates a cohort of loans or loan guarantees is expected to cost the federal government less than previously anticipated. This amount does not include the portion of the reestimate attributable to interest.

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Background

- Prior to the Federal Credit Reform Act (FCRA) of 1990, credit programs--like most other federal programs--were reported in the budget on a cash basis.
  - Loan guarantees appeared to be free in the budget year while direct loans appeared to be as expensive as grants.
  - This cash basis distorted costs and, thus, the comparison of credit program costs with other programs and each other.

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Background

- FCRA was, among other reasons, enacted to more accurately measure the government's costs of federal loan programs and to permit better comparisons both among credit programs and between credit and noncredit programs.

- Under FCRA, agencies are required to estimate the cost of extending or guaranteeing credit over the life of the loan, called the subsidy cost.

  - This cost is the estimated long-term cost to the government of direct loans or loan guarantees calculated on a net present value[4] basis, excluding administrative costs.

[4] The net present value expresses expected future cash inflows and outflows in today's dollars. In calculating the present value, prevailing interest rates provide the basis for converting future amounts into today's dollar equivalents.

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Background

- In the subsidy cost calculation, agencies estimate the cash flows for a program, including (but not limited to) estimated defaults, recoveries, and fees, and the effects of prepayments, on a cohort basis, for the life of the loans.

- Generally, agencies are required to annually update the subsidy cost - referred to as reestimates - of each cohort based on information about the actual performance and/or estimated changes in future loan performance.

    - FCRA recognized that agencies' ability to make subsidy cost estimates that mirrored actual loan performance could be impeded by various factors and provided permanent indefinite budget authority for reestimates that reflect increased credit program costs.

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Background

- Section 503 of FCRA states that OMB is responsible for, among other things,
  - coordinating subsidy cost estimates for executive branch agencies and
  - reviewing historical data and developing the best possible credit subsidy estimates.
- The Accounting and Auditing Policy Committee's[5] (AAPC) Technical Release 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, identifies specific practices that, if fully implemented by credit agencies, will enhance their ability to reasonably estimate loan program costs.

[5] The AAPC is sponsored by the Federal Accounting Standards Advisory Board.

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Process and Data Used to Estimate 7(a) Subsidy Costs

- When calculating the subsidy cost of the 7(a) program, SBA considers, for the life of the loans guaranteed

  (1) fees that will be received,
  (2) the percent of total loan amounts guaranteed, which currently can not exceed 75 or 85 percent depending on the loan amount,
  (3) the volume and mix of loan guarantees,[6] and
  (4) the amount and timing of defaults and recoveries.

- To estimate defaults and recoveries, SBA averages its historical loan performance since 1986.[7]

[6] The volume and mix of loan guarantees refers to the total amount of loans SBA expects to guarantee and the various loan sizes based upon different fee and guaranteed percentages.
[7] SBA began using this historical database in 1996 to calculate the subsidy cost of the 1998 cohort.

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Process and Data Used to Estimate 7(a) Subsidy Costs

- According to SBA staff, when there is a change in the 7(a) program's design, SBA staff
    - determine if the change affects existing assumptions or adds a new assumption to the subsidy cost calculation,
    - determine if there is any historical data that could be used to assess the impact of the change on the subsidy cost estimates, and
    - use informed opinion[8] to estimate the impact on the subsidy cost if no applicable historical experience exists.

[8] Informed opinion refers to the judgment of agency staff who make subsidy estimates based on their programmatic knowledge and/or experience. According to Technical Release 3, informed opinion is an acceptable approach in situations where historical data does not exist.

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Process and Data Used to Estimate 7(a) Subsidy Costs

- SBA generally uses the same process and types of data as explained on the prior two slides to calculate reestimates of subsidy costs. In addition, as part of the reestimate process,

  - as actual loan performance becomes available, it replaces estimated cash flows and

  - expectations of future loan performance are updated based on information about actual performance and/or estimated changes in future loan performance.

- In summary, the process and types of data SBA uses to estimate the subsidy cost of the 7(a) program are generally reasonable and comply with existing OMB guidance.

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Reestimates of the 7(a) Program Subsidy Costs

- Since the inception of credit reform, SBA has overestimated the original subsidy cost of the 7(a) program by nearly $1 billion, as evidenced by the net downward reestimate shown on the following slide.

- Because reestimate data were not separately available for interest, defaults, fees and other cash flows, we were unable to determine the net overestimate attributable to each of these factors.

- However, based on our comparisons of originally estimated defaults and recoveries to actual loan performance, a significant portion of the 7(a) program's total $1 billion net reestimate is attributed to the overestimate of defaults.

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Reestimates of the 7(a) Program Subsidy Costs

Reestimate History of the 7(a) Program
(Dollars in millions)

Cohort	1997 Budget	1998 Budget	1999 Budget	2000 Budget	2001 Budget	2002 Budget	Cummulative
1992	$5	($55)	($30)	($74)	($5)	($4)	($163)
1993	(14)	(77)	(50)	(80)	(21)	(16)	(259)
1994	53	(14)	(63)	(60)	(12)	(4)	(100)
1995	11	49	(68)	(60)	(1)	(4)	(73)
1996		32	37	(101)	(16)	(9)	(57)
1997			(24)	(86)	(39)	(0)	(149)
1998				(52)	(39)	(39)	(130)
1999					(13)	(11)	(24)
2000						(3)	(3)
Totals	$54	($65)	($198)	($513)	($145)	($91)	($958)

Source: Small Business Administration

Note: For each annual reestimate, net amounts were either received from Treasury (1997 Budget) or returned to Treasury (1998 - 2002 Budget).

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Comparison of Originally Estimated Defaults and Recoveries to Actual Data

- SBA originally overestimated defaults[9] for 1992 through 2000 by over $2 billion, or about 87 percent, when compared to actual loan performance.

- Since estimated recoveries are based on a percent of estimated defaults, SBA also originally overestimated recoveries for 1992 through 2000 by nearly $450 million, or about 62 percent, when compared to actual loan performance.

- According to SBA staff, overestimating fees also contributed to the 7(a) program total net reestimate. However, we did not attempt to quantify the effect of fees.[10]

[9] The amount defaulted is based on the portion SBA guarantees.
[10] In addition to the differences between actuals and estimates to date, the net reestimate would also be impacted by the present value of these differences and changes in the estimates for expected future loan performance.

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Comparison of Originally Estimated Defaults and Recoveries to Actual Data

- The following 4 slides summarize the results of our comparison of original estimates of defaults and recoveries to actual defaults and recoveries for the 1992 through 2000 cohorts.

- The original estimates of defaults and recoveries for each cohort are based on expectations of future loan performance from the time of origination through fiscal year 2000. Actual defaults and recoveries for each cohort are based on actual loan performance through fiscal year 2000.

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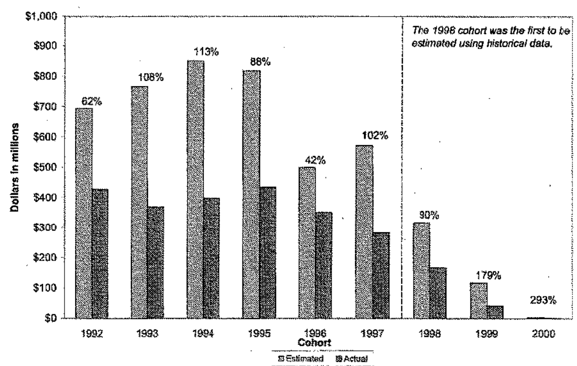
Comparison of Originally Estimated Defaults and Recoveries to Actual Data

Percentage by which Originally Estimated Defaults were more than Actual Defaults for Fiscal Years 1992 through 2000 (Cumulatively by Cohort)



Source: GAO analysis based on SBA data.
Note: By the end of fiscal year 2000, only the 1992 through 1996 cohorts had reached the typical peak default years, which historically have been years 3 through 5 after approval.

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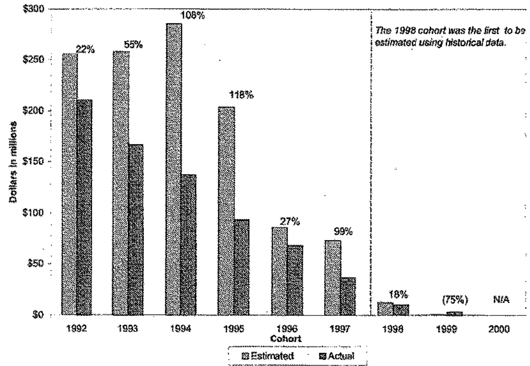
Comparison of Originally Estimated Defaults and Recoveries to Actual Data

Percentage by which Originally Estimated Recoveries were more (less) than Actual Recoveries for Fiscal Years 1992 through 2000 (Cumulatively by Cohort)



Source: GAO analysis based on SBA data
Note: N/A indicates that there were no actual recoveries as expected for a cohort in its first year.

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Comparison of Originally Estimated Defaults and Recoveries to Actual Data

- In order to assess estimated recoveries independently from the effect of overestimating defaults, we compared estimated recoveries based on actual defaults to actual recoveries.

- This comparison, summarized on the next slide, showed that adjusting for the effect of originally overestimating defaults, estimated recoveries have more closely matched actual loan performance over time.

    - The cumulative difference between the adjusted estimate of recoveries and actual recoveries was about $3 million, or about 1 percent of actual recoveries.

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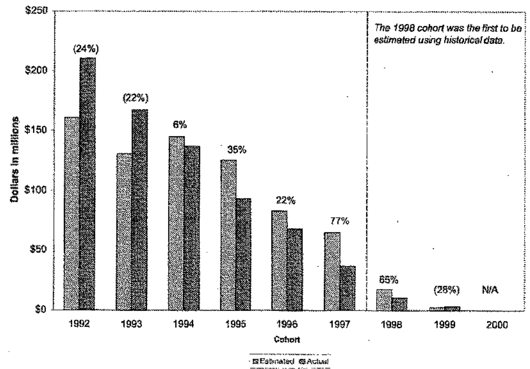
Comparison of Originally Estimated Defaults and Recoveries to Actual Data

Percentage by which Adjusted Estimated Recoveries were more (less) than Actual Recoveries for Fiscal Years 1992 through 2000 (Cumulatively by Cohort)



Source: GAO analysis based on SBA data.
Note: Estimated recoveries were adjusted to be based upon actual defaults in order to remove the effect of overestimating defaults. N/A indicates that there were no actual recoveries for the cohort, as expected for a cohort in its first year.

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Effect of Overestimating the 7(a) Program's Subsidy Cost

- Because the 7(a) program is a discretionary credit program, overestimating the cost can affect the number or size of loans guaranteed, if the program runs out of budget authority.

- However, according to SBA and OMB, the 7(a) program has typically not depleted its allocated budget authority and has generally met its demand for loan guarantees.

  - According to SBA, the 7(a) program did run out of budget authority a few days before the end of fiscal year 1995, preventing SBA from issuing some loan guarantees. However, SBA issued loan guarantees for those loans the following fiscal year. Further, for a part of 1997, SBA established a temporary cap on the size of loans it guaranteed, which limited the amount of subsidy available per loan.

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Effect of Overestimating the 7(a) Program's Subsidy Cost

- Appropriations for the original 7(a) program subsidy cost, like other discretionary credit programs, are counted under the discretionary spending caps and must compete with other discretionary programs for the funding available under these limits.

- The cumulative result of the overestimates of the subsidy cost of the 7(a) program is that $958 million of budget authority was not available for other discretionary programs for fiscal years 1992 through 2000.

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Causes of Differences

- For the 1992 through 1997 cohorts,[11] the specific reason for the differences between originally estimated and actual defaults is unclear because the basis of the estimate is unknown.
  - SBA did not begin to use its historical data until 1996, when it calculated the original subsidy cost estimate for the 1998 cohort.
  - According to SBA officials, prior to 1996, subsidy cost estimates were prepared based on direct consultation with OMB and the basis used for the default estimates was not documented.
  - However, SBA believes one of the reasons for the differences was an unexpected good economy.

[11] Reestimates of the 1992 through 1997 cohorts have accounted for 84 percent of the 7(a) program's total downward reestimate.

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Causes of Differences

- The reason for the differences between originally estimated and actual defaults for the 1998 through 2000 cohorts is that the historical average default rate used as the basis for the default estimate was greater than recent loan performance.
    - The historical average default rate was higher because loans guaranteed in fiscal years 1986 through 1990 defaulted at a significantly higher rate than those for later years.
    - SBA attributes the high default rates in fiscal years 1986 through 1990 generally to differences in (1) economic conditions, (2) guarantee percentages, and (3) underwriting standards.
    - The loans in the 1998 through 2000 cohorts are still relatively new and have not yet reached the typical peak default years, which historically have been years 3 through 5 after approval.

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Implications of Proposed Changes

- In March 2001, SBA submitted a proposal to OMB[12] that discusses using 5 years or 3 years of the most recent actual loan performance - referred to as the lookback period[13] - as the basis for the 7(a) program default estimate in order to more closely track with actual loan performance in the future. SBA recommends the 5 year lookback period.

    - This proposal is based on SBA's analysis that showed that the most recent years of actuals are more predictive of near-term future loan performance, notwithstanding a sudden shift in the economy.

[12] In the past, SBA has proposed other methods to refine its default estimates to OMB. According to OMB, SBA has not provided acceptable support that the alternatives would provide better estimates.
[13] For example, under the 5 year lookback period, the 2002 cohort estimate of year one default activity would be based on the average actual first year defaults that occurred for the 1996 through 2000 cohorts and the second year default activity would be based on actual second year defaults that occurred for the 1995 through 1999 cohorts.

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Implications of Proposed Changes

- Because the lookback period is shorter, original subsidy cost estimates, as well as annual reestimates of outstanding cohorts, would be more sensitive to fluctuations in economic conditions or changes in program delivery and design.

- The benefit of this approach is that in a continuing stable economy, the original subsidy cost estimate would be expected to more closely match actual loan performance and reestimates would therefore be smaller.

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Implications of Proposed Changes

- However, the risk of this approach is that a sudden downturn in the economy would be much more likely to result in actual loan performance being different than estimated and thus could result in larger reestimates.

- If SBA were to implement a shorter lookback period approach, its next reestimate would likely be large because expectations of future loan performance of outstanding cohorts would also be impacted by the change.

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Implications of Proposed Changes

- Under SBA's current approach, initial estimates of the subsidy rate are fairly stable because of the longer lookback period, which smoothes out fluctuations in economic conditions from year to year.
  - This approach is based on the concept that, averaging "good" and "bad" years is the best way to estimate the effect of uncertain future economic conditions.
  - The benefit of this approach is that it provides a "cushion" in the event of an unexpected downturn in the economy.

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Implications of Proposed Changes

- The consequence of this approach is that the "cushion" ties up appropriations that could have been available to other discretionary programs.
- This approach is also more likely to result in continuing annual downward reestimates in a strong economic environment.
- However, in a less favorable economy, the current approach may result in original subsidy cost estimates that are closer to actual loan performance than the proposed 5 year lookback approach.

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Implications of Proposed Changes

- The following table contrasts the impact of using the current approach, a 5 year lookback, and a 3 year lookback to estimate the subsidy cost of the fiscal year 2002 cohort.

Estimation Alternatives' Effect on Subsidy Rate and Appropriation for the Fiscal Year 2002 Cohort

	Default Rate	Subsidy Rate	Appropriation
Current Approach	13.87%	1.07%	$114,490,000
5 Year Lookback	9.74%	-0.40%	-$42,800,000
3 Year Lookback	8.97%	-0.61%	-$65,270,000

Source: GAO analysis based on SBA data.

Note: Estimated appropriation assumes that all other assumptions remain unchanged.

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Implications of Proposed Changes

- For both the 5 year and 3 year lookback approach, we estimated a negative subsidy, meaning that the program is estimated to "make money" for the federal government.
  - We estimated that the 5 year and 3 year lookback would project a negative subsidy of $43 million and $65 million, respectively, versus a subsidy cost of $114 million under the current approach.

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Agency Comments

- SBA generally agreed with the information presented in this briefing. SBA officials added that they view the proposed change in the default estimation methodology to be an interim solution. SBA views the long-term solution as a sophisticated econometric modeling approach.
  - Econometric modeling is meant to include any estimated quantitative method of analysis. It defines key relationships between loan performance and economic and other indicators.
  - SBA has already started work on this type of methodology.

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SBA

Financing Your Business
Loan Programs

7a Loan Guaranty
SBALowDoc
SBAExpress
SBA Export *Express*
Community Express
CAIP
CDC - 504 Loans
CAPLines
International Trade
Export Working Cap
Pollution Control
DELTA
Prequal Pilot
Disable Assist
Qual Empl Trusts
Veterans
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Comments

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Financing Your Business

7(A) Loan Guaranty Program

GENERAL DESCRIPTION

The 7(a) Loan Guaranty Program is one of SBA's primary lending programs. It provides loans to small businesses unable to secure financing on reasonable terms through normal lending channels. The program operates through private-sector lenders that provide loans which are, in turn, guaranteed by the SBA -- the Agency has no funds for direct lending or grants.

Most lenders are familiar with SBA loan programs so interested applicants should contact their local lender for further information and assistance in the SBA loan application process. Information on SBA loan programs, as well as the management counselling and training services offered by the Agency, is also available from the local SBA office.

LOAN AMOUNTS AVAILABLE UNDER SBA LOAN PROGRAMS

Effective December 22, 2000, a maximum loan amount of $2 million has been established for 7(a) loans. However, the maximum dollar amount the SBA can guaranty is generally $1 million. Small loans carry a maximum guaranty of 85 percent. Loans are considered small if the gross loan amount is $150,000 or less. For loans greater than $150,000, the maximum guaranty is 75 percent.

WHAT SBA SEEKS IN A LOAN APPLICATION

Repayment ability from the cash flow of the business is a primary consideration in the SBA loan decision process but good character, management capability, collateral, and owner's equity contribution are also important considerations. All owners of 20 percent or more are required to personally guarantee SBA loans.

WHO IS ELIGIBLE FOR AN SBA LOAN

Although most small businesses are eligible for SBA loans, some types of businesses are ineligible and a case-by-case determination must be made by the Agency. Eligibility is generally determined by four factors:

Type of Business

Size of Business

Use of Loan Funds

Special Circumstances

TYPE OF BUSINESSES ELIGIBLE:

The vast majority of businesses are eligible for financial assistance from the SBA. However, applicant businesses must operate for profit; be engaged in, or propose to do business in, the United States or its possessions; have reasonable owner equity to invest; and, use alternative financial resources first including personal assets. It should be noted that some businesses are ineligible for financial assistance.

SIZE OF BUSINESSES ELIGIBLE:

The Small Business Act defines an eligible small business as one that is independently owned and operated and not dominant in its field of operation. The Act also states that in determining what is a small business, the definition shall vary from industry to industry to adequately reflect industry differences. The SBA has therefore developed size standards that define the maximum size of an eligible small business.

As apparent from the following general description of SBA's size standards, most businesses are considered small. However, these represent general definitions that in some cases are further defined by specific SIC code.

Industry	Size
Retail and Service	$3.5 to $13.5 million
Construction	$7.0 to $17.0 million
Agriculture	$0.5 to $3.5 million
Wholesale	No more than 100 employees
Manufacturing	500 to 1,500 employees

If a potential borrower is close to these standards, size eligibility should be discussed with the local SBA office. Also note that the standards for a particular business may change from time to time and some exceptions do apply.

When affiliations exist with other companies (for example, through common ownership, directorships, or by contractual arrangements), the primary business activity must be determined both for the applicant business as well as for the entire affiliated group. In order to be eligible for financial consideration, the applicant must meet the size standard for its primary business activity and the affiliated group must meet the standard for its primary business activity.

USE OF PROCEEDS:

The proceeds of SBA loans can be used for most business purposes. These may include the purchase of real estate to house the business operations; construction, renovation or leasehold improvements; acquisition of furniture, fixtures, machinery, and equipment; purchase of inventory; and, working capital.

PROCEEDS OF AN SBA LOAN CANNOT BE USED:

* to finance floor plan needs;

* to purchase real estate where the participant has issued a forward commitment to the builder/developer, or where the real estate will be held primarily for investment purposes;

* to make payments to owners or pay delinquent withholding taxes;

* to pay existing debt unless it can be shown that the refinancing will benefit the small business and that the need to refinance is not indicative of imprudent management. (Proceeds can never be used to reduce the exposure of the participant in the loans being refinanced.)

SPECIAL CIRCUMSTANCES:

Certain other considerations apply to the types of businesses and applicants eligible for SBA loan programs.

<u>Franchises</u>

<u>Recreational Facilities and Clubs</u>

<u>Farms and Agriculture</u>

<u>Fishing Vessels</u>

<u>Medical Facilities</u>

<u>EPC</u>

<u>Change of Ownership</u>

<u>Aliens</u>

<u>Probation or Parole</u>

Academic Schools

FRANCHISES - are eligible except in situations where a franchisor retains power to control operations to such an extent as to be tantamount to an employment contract. The franchisee must have the right to profit from efforts commensurate with ownership.

RECREATIONAL FACILITIES AND CLUBS - are eligible provided: (a) the facilities are open to the general public, or (b) in membership only situations, membership is not selectively denied to any particular group of individuals and the number of memberships is not restricted either as a whole or by establishing maximum limits for particular groups.

FARMS AND AGRICULTURAL BUSINESSES - are eligible; however, these applicants should first explore Farmers Home Administration (FmHA) programs, particularly if the applicant has a prior or existing relationship with FmHA.

FISHING VESSELS - are eligible; however, those seeking funds for the construction or reconditioning of vessels with a cargo capacity of five tons or more must first request financing from the National Marine Fisheries Service (NMFS), a part of the Department of Commerce.

MEDICAL FACILITIES - hospitals, clinics, emergency outpatient facilities, and medical and dental laboratories are eligible. Convalescent and nursing homes are eligible, provided they are licensed by the appropriate government agency and services rendered go beyond those of room and board.

An Eligible Passive Company (EPC) is a small entity which does not engage in regular and continuous business activity. An EPC must use loan proceeds to acquire or lease, and/or improve or renovate real or personal property that it leases to one or more Operating Companies for conducting the Operating Company's business. The EPC must comply with the conditions set forth in 13 CFR Sec 120.111.

CHANGE OF OWNERSHIP - Loans for this purpose are eligible provided the business benefits from the change. In most cases, this benefit should be seen in promoting the sound development of the business or, perhaps, in preserving its existence. Loans cannot be made when proceeds would enable a borrower to purchase: (a) part of a business in which it has no present interest or (b) part of an interest of a present and continuing owner. Loans to effect a change of ownership among members of the same family are discouraged.

ALIENS - are eligible; however, consideration is given to the type of status possessed, e.g., resident, lawful temporary resident, etc. in determining the degree of risk relating to the continuity of the applicant's business. Excessive risk may be offset by full collateralization. The various types of visas may be discussed in more detail with the local SBA office.

PROBATION OR PAROLE - applications will not be accepted from firms where a principal (any one of those required to submit a personal history statement, SBA Form 912):

1) is currently incarcerated, on parole, or on probation;
2) is a defendant in a criminal proceeding; or
3) whose probation or parole is lifted expressly because it prohibits an SBA loan.

This restriction would not necessarily preclude a loan to a business, where a principal had responded in the affirmative to any one of the questions on the Statement of Personal History. These judgments are made on a case by case evaluation of the nature, frequency, and timing of the offenses. Fingerprint cards (available from the local SBA office) are required any time a question on the form is answered in the affirmative.

INELIGIBLE BUSINESSES:

Businesses cannot be engaged in illegal activities, loan packaging, speculation, multi sales distribution, gambling, investment or lending, or where the owner is on parole.

Specific types of businesses not eligible include:

Real Estated Investment and Other Speculative Activities

Lending Activities
Pyramid Sales Plans
Illegal Activities
Gambling Activities
Charitable, Religious, or Certain Other Nonprofit Institutions

REAL ESTATE INVESTMENT firms exist when the real property will be held for investment purposes - as opposed to loans to otherwise eligible small business concerns for the purpose of occupying the real estate being acquired. OTHER SPECULATIVE ACTIVITIES are those firms developing profits from fluctuations in price rather than through the normal course of trade, such as wildcatting for oil and dealing in commodities futures, when not part of the regular activities of the business. Dealers of rare coins and stamps are not eligible.

LENDING ACTIVITIES include banks, finance companies, factors, leasing companies, insurance companies (not agents), and any other firm whose stock in trade is money.

PYRAMID SALES PLANS are characterized by endless chains of distributors and sub-distributors where a participant's primary incentive is based on the sales made by an ever-increasing number of participants. Such products as cosmetics, household goods, and other soft goods lend themselves to this type of business.

ILLEGAL ACTIVITIES are by definition those activities which are against the law in the jurisdiction where the business is located. Included in these activities are the production, servicing, or distribution of otherwise legal products that are to be used in connection with an illegal activity, such as selling drug paraphernalia or operating a motel that permits illegal prostitution.

GAMBLING ACTIVITIES include any business whose principal activity is gambling. While this precludes loans to race tracks, casinos, and similar enterprises, the rule does not restrict loans to otherwise eligible businesses, which obtain less than one-third of their annual gross income from either: 1) the sale of official state lottery tickets under a state license, or 2) legal gambling activities licensed and supervised by a state authority.

CHARITABLE, RELIGIOUS, OR OTHER NON-PROFIT or eleemosynary institutions, government-owned corporations, consumer and marketing cooperatives, and churches and organizations promoting religious objectives are not eligible.

SBA LOAN MATURITIES

SBA loan programs are generally intended to encourage longer term small business financing but actual loan maturities are based on the ability to repay, the purpose of the loan proceeds, and the useful life of the assets financed. However, maximum loan maturities have been established: twenty-five (25) years for real estate and equipment; and, generally seven (7) years for working capital.

Loans for working capital purposes will not exceed seven (7) years, except when a longer maturity (up to 10 years) may be needed to ensure repayment. The maximum maturity of loans used to finance fixed assets other than real estate will be limited to the economic life of those assets - but in no instance to exceed twenty-five (25) years. The 25-year maximum will generally apply to the acquisition of land and buildings or the refinancing of debt incurred in their acquisition. Where business premises are to be constructed or significantly renovated, the 25-year maximum would be in addition to the time needed to complete construction. (Significant renovation means construction of at least one-third of the current value of the property.)

INTEREST RATES APPLICABLE TO SBA LOANS

Interest rates are negotiated between the borrower and the lender but are subject to SBA maximums, which are pegged to the Prime Rate.

Interest rates may be fixed or variable. Fixed rate loans of $50,000 or more must not exceed Prime Plus 2.25 percent if the maturity is less than 7 years, and Prime Plus 2.75 percent if the maturity is 7 years or more.

For loans between $25,000 and $50.000, maximum rates must not exceed Prime Plus 3.25 percent if the maturity is less than 7 years, and Prime Plus 3.75 percent if the maturity is 7 years or more.

For loans of $25,000 or less, the maximum interest rate must not exceed Prime Plus 4.25 percent if the maturity is less than 7 years, and Prime Plus 4.75 percent, if the maturity is 7 years or more.

Variable rate loans may be pegged to either the lowest prime rate or the SBA optional peg rate. The optional peg rate is a weighted average of rates the federal government pays for loans with maturities similar to the average SBA loan. It is calculated quarterly and published in the "Federal Register." The lender and the borrower negotiate the amount of the spread which will be added to the base rate. An adjustment period is selected which will identify the frequency at which the note rate will change. It must be no more often than monthly and must be consistent, (e.g., monthly, quarterly, semiannually, annually or any other defined, consistent period).

FEES ASSOCIATED WITH SBA LOANS

To offset the costs of the SBA's loan programs to the taxpayer, the Agency charges lenders a guaranty and a servicing fee for each loan approved. These fees can be passed on to the borrower once they have been paid by the lender. The amount of the fees are determined by the amount of the loan guaranty.

Effective December 22, 2000, when the loan amount is $150,000 or less, the guaranty fee will be 2 percent of the guaranteed portion. Lenders are permitted to retain 25 percent of this fee (50 basis points). This is only applicable to loans of $150,000 or less. For loans more than $150,000 but up to and including $700,000, a 3 percent guaranty fee will be charged. For loans greater than $700,000, a 3.5 percent guaranty fee will be charged.

In addition, all loans will be subject to a fifty basis point (0.5%) annualized servicing fee, which is applied to the outstanding balance of SBA's guaranteed portion of the loan.

PROHIBITED FEES:

Processing fees, origination fees, application fees, points, brokerage fees, bonus points, and other fees that could be charged to an SBA loan applicant are prohibited. The only time a commitment fee may be charged is for a loan made under the Export Working Capital Loan Program.

GUARANTY PERCENTS

For those applicants that meet the SBA's credit and eligibility standards, the Agency can guaranty up to 85 percent of loans of $150,000 and less, and up to 75 percent of loans above $150,000 (generally up to a maximum guaranty amount of $1,000,000).

PREPAYMENT

Effective for all loans where the applications were received by the lender on or after December 22, 2000, a new prepayment charge paid by the borrower to SBA ("subsidy recoupment fee") has been added for those loans that meet the following criteria:

a. have a maturity of 15 years or more where the borrower is prepaying voluntarily;

b. the prepayment amount exceeds 25 percent of the outstanding balance of the loan; AND

c. the prepayment is made within the first 3 years after the date of the first disbursement (not approval) of the loan proceeds.

The prepayment fee calculation is as follows:

a. during the first year after disbursement, 5 percent of the amount of the prepayment;

b. during the second year after disbursement, 3 percent of the amount of the prepayment; or

c. during the third year after disbursement, 1 percent of the amount of the prepayment.

NATIONAL ASSOOCIATION OF GOVERN-
MENT GUARANTEED LENDERS, INC.
(August 30, 2001)

7(a) Loan Guarantee Fees

Sec. 2. Section 7(a)(18) of the Small Business Act (15 U.S.C. 636(a)(18)) is amended as follows:

(1) by striking from subparagraph (A)(i) "$150,000" and by inserting in lieu thereof "$250,000"; and

(2) by striking from subparagraph (A)(ii) "$150,000" and by inserting in lieu thereof "$250,000".

Sec. 3. Section 7(a)(23) of the Small Business Act (15 U.S.C. 636(a)(23)) is amended by striking from paragraph (A) "0.5 percent" and by inserting in lieu thereof "0.25 percent".

Sec. 4. This Act shall apply to loans approved on or after October 1, 2002.

Explanation

Loans guaranteed under section 7(a) of the Small Business Act require the payment of two fees:

(1) a fee paid by lender but which may be passed-on to the borrower and is based on the amount of the loan:

- 2% on the guaranteed portion if the total loan is $150,000 or less;
- 3% on the guaranteed portion if the total amount of the loan is more than $150,000 but not more than $700,000; and

- 3.5% on the guaranteed portion if the total loan is more than $700,000.

Section 2 of the bill would increase the size of the first tier by $100,000 so that borrowers would pay 2% on the guaranteed portion if the total amount of the loan is $250,000 or less.

(2) an annual fee of .5% (or one-half of one percent) paid by the lender which is prohibited from being passed-on to the borrower.

Section 3 would reduce the amount of this fee to .25% (or one-fourth of one percent).

Section 4 would make these fee changes effective at the beginning of fiscal year 2003 (or October 1, 2002).

Rationale

Since the inception of the 7(a) loan program, the Government has supported small business loan guarantees by appropriating funds to pay a majority of the direct costs of the program while collecting a minority of these costs from program participants. For example, for fiscal year 1995, the government appropriated $195 million which, when added to borrower/lender fees, supported a program level of $7.1 billion at a subsidy rate of 2.75%.

Effective at the beginning of fiscal year 1996, however, the borrower fees were increased substantially and a new fee was imposed on the lender. That year, for the first time, the Government paid a minority of the direct costs and a majority of the cost was borne by borrowers/lenders. That year the Government paid only 1.06% while even the smallest loans (those up to $80,000) paid 2% or twice that amount, while larger borrowers paid up to a maximum rate of up to 3.85% plus a new annual fee of .5% being paid by the lender.

For the current fiscal year, 2001, the government provided an appropriation of $115 million to support $10 billion in 7(a) guarantees at a subsidy rate of 1.17%, with the balance coming from borrower/lender fees.

NAGGL estimates that in fiscal year 1995 (the last year before major fee increases) program participants (borrowers and lenders) paid about one-half of the direct program costs while the Government also paid one-half. This compares with 2001 in which NAGGL estimates that program participants will pay 80% of the cost while the Government will pay only 20%.

In addition, OMB continues to report that it has been overestimating the cost of this program and since 1992 (the implementation of the Credit Reform Act). During fiscal years 1996-2001 reestimates show that the government has collected $1.258 billion more than the program has cost to operate during the past six years. DUE TO THE RATIO BETWEEN FEES AND APPROPRIATIONS DURING THIS TIME FRAME, MOST OF THIS MONEY HAS BEEN PAID BY BORROWERS AND LENDERS. VIEWED ANOTHER WAY, THE GOVERNMENT HAS BEEN OPERATING THE 7(a) PROGRAM AT A SUBSTANTIAL PROFIT DURING THE PAST SIX YEARS DUE TO THE IMPOSITION OF AN UNAUTHORIZED TAX ON 7(a) LOAN BORROWERS AND LENDERS.

We expect OMB to project a cost estimate for the 7(a) loan program at or below zero for fiscal year 2003. This bill, reducing user fees at that time, simply provides that the Government shall continue to pay a very minor share of the cost of the program and thus continue its historic role of supporting small business.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

AUG 3 2001

Honorable Donald Manzullo
Chairman
Committee on Small Business
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Thank you for your letter of July 23, 2001, regarding the U.S. Small Business Administration's (SBA) subsidy rate calculation for the Section 7(a) and 504 loan programs. As you are aware, at the SBA's FY 2002 Budget Hearing before your Committee, the Administration agreed to examine the loan subsidy rate calculations this summer. At this time, the Office of Management and Budget and SBA are continuing the review of the default calculation and considering many options that are intended to improve the predictiveness of the FY 2003 subsidy rate calculation modeling, including the option of using the 10 year "lookback" period for the 7(a) program.

While the example below is representative of what the subsidy rate might have been using different assumptions, under the Federal Credit Reform Act (FCRA) of 1990, agencies cannot change the economic or technical assumptions underlying the subsidy cost estimate after submission of the President's budget. Therefore, SBA will use the assumptions included in the President's budget when calculating the FY 2002 subsidy rate for its loan programs.

Our responses regarding SBA's 7(a) and 504 program are as follows:

"Recalculate each program's current subsidy rate using a 10 year "lookback" period."

7(a):	
--Current Services	1.07%
--10 year lookback	0.49%
504:	
--Current Services	0.00% with fee of .41%
--10 year lookback	0.00% with fee of .14%

Please note, the results achieved above are based on a preliminary and incomplete analysis of the data and could change considerably upon additional analysis and verification by the Office of Management and Budget and our independent auditors.

"We understand that, in the model, no income is derived from a 7(a) loan after the 8th year. Conversely, defaults on 7(a) loans are still accounted for in years 9 through 14. If this is accurate, as appears from agency material, and a loan is producing no income after 8 years then it has been paid off and cannot default."

RESPONSE: Although not readily apparent in reviewing, all fee revenues and recoveries are included in the subsidy rate calculation for the average maturity of the 7(a) loans, or the same period as defaults.

Even with the shortened "lookback" period, Congress made substantial changes to the 7(a) program in 1995. For example, lender exposure on loans increased and the 50 basis point fee on the outstanding balance of each loan was instituted. In short, the program post-1995 looks nothing like the program pre-1995. While reduced program defaults since 1995 can be partially attributed to a strong economy, some credit must be ascribed to these programmatic changes.

RESPONSE: The 7(a) model does account for all of these legislative changes made to the program in the "assumptions" used to derive the final subsidy rate.

With respect to the 504 loan program:

" We understand that, in the model, no income is derived from a 7(a) loan after the 8th year. Conversely, defaults on 7(a) loans are still accounted for in years 9 through 14. If this is accurate, as appears from agency material, and a loan is producing no income after 8 years then it has been paid off and cannot default."

RESPONSE: The model does include the effect of actual performance. The 4 percent does not appear to consider the effect of seasoning cohorts.

"Based on SBA's own statistics, from both asset sales and portfolio management activity, the recovery rate on 504 defaulted debentures is much higher than the 26 percent assumption used in the model. Although the recovery rate has only a limited effect on the overall subsidy rate, small business borrowers should nevertheless not pay higher fees as a result of this than is necessary."

RESPONSE: For the 20-year 504 debentures, the FY 2002 model includes an assumed recovery rate of 67.67%, offset by an expected expense rate of 41.08%, producing a "net recovery rate" of 26.59%.

As soon as we conclude our examination of the subsidy methodology, we will provide this information to the Committee. Please let us know if you have additional questions or would like more information.

Sincerely,

John Whitmore

John Whitmore